# Michelle W Bowman: Reflections on the economy and bank regulation

Speech by Ms Michelle W Bowman, Member of the Board of Governors of the Federal Reserve System, at the New Jersey Bankers Association Annual Economic Leadership Forum, Somerset, New Jersey, 7 March 2024.

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I would like to thank the New Jersey Bankers Association for the invitation to share my thoughts with you today.[1] While I welcome the opportunity to share my thoughts about monetary policy, the economy, and the path of regulatory reform, I find it even more valuable to hear your views on local banking and economic conditions in the communities you serve, and your perspectives on trends in bank regulation and supervision. These conversations provide valuable insights to inform my work at the Federal Reserve-both for my understanding of the economy and the banking environment.

Before discussing bank regulation, I would like to briefly touch on the economy and monetary policy.

## Monetary Policy

Over the past two years, the Federal Open Market Committee (FOMC) has significantly tightened the stance of monetary policy to address high inflation. At our most recent meeting in January, we voted to continue to hold the federal funds rate target range at 5-1/4 to 5-1/2 percent and to continue to reduce the Federal Reserve's securities holdings.

We have seen continued progress on inflation over the past year, with the 12-month readings through January of total and core personal consumption expenditures (PCE) inflation moving down to 2.4 percent and 2.8 percent, respectively, both at the lowest rates we have seen since early 2021. Although inflation declined over the second half of 2023, the January inflation data suggest that progress in bringing inflation down further may be slower going forward. Throughout this time, economic activity has remained strong with ongoing strength in consumer spending. We had also seen signs of the labor market coming into better balance, but recent strong jobs reports-including upward revisions to employment growth-show a continued tight labor market. Last year, the average pace of job gains slowed and the labor force participation rate rose through November, with the unemployment rate edging up to 3.7 percent. In recent months, however, job growth has rebounded, and the labor force participation rate declined, retracing some of its earlier gains.

At its current setting, our monetary policy stance is restrictive and appears to be appropriately calibrated to reduce inflationary pressures. As I've noted recently, my baseline outlook continues to be that inflation will decline further with the policy rate held steady, but I still see a number of upside inflation risks that affect my outlook. These include risks from geopolitical developments, including the risk of spillovers from geopolitical conflicts and the extent to which food and energy markets and supply chains remain exposed to these influences. There is also the risk that a loosening in financial conditions and additional fiscal stimulus could add momentum to demand,

stalling any further progress or even causing inflation to reaccelerate. Finally, there is a risk that continued labor market tightness could lead to persistently high core services inflation. Recent labor market data suggest ongoing elevated wage growth as some businesses continue to report above-average wage increases to compensate for elevated prices and high inflation.

Given these risks, and the general uncertainty regarding the economic outlook, I will continue to watch the data closely as I assess the appropriate path of monetary policy. The frequency and extent of data revisions over the past few years, as seen in the most recent employment report, make the task of assessing the current state of the economy as well as predicting how the economy will evolve even more challenging, and I will remain cautious in my approach to considering future changes in the stance of policy. Should the incoming data continue to indicate that inflation is moving sustainably toward our 2 percent goal, it will eventually become appropriate to gradually lower our policy rate to prevent monetary policy from becoming overly restrictive. In my view, we are not yet at that point. Reducing our policy rate too soon could result in requiring further future policy rate increases to return inflation to 2 percent over the longer run.

It is important to note that monetary policy is not on a preset course. My colleagues and I will make our decisions at each FOMC meeting based on the incoming data and the implications for the outlook. While the current stance of monetary policy appears to be at a restrictive level that will bring inflation down to 2 percent over time, I remain willing to raise the federal funds rate 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.

## Notable Developments in Bank Regulation and Supervision

As I look at the bank regulatory agenda, I am struck by the sheer volume of matters that have recently been completed, that have been proposed, and that are in the pipeline. These reforms touch on a wide range of topics that directly or indirectly impact banks of all sizes. This work shows no signs of slowing down. The large number of finalized, proposed, and potential changes suggest insufficient prioritization in furthering the primary goal of prudential bank regulation and supervision-promoting a safe and sound banking system. In fulfilling this statutory objective, we must also focus on efficiency and effectiveness and always consider how regulatory reforms affect the banking market, the economy, and those who use banking services. We should also ensure, in our pursuit of reform, that our efforts result in a bank framework that is appropriately tailored and calibrated.

I have spoken at length over the past few months about some recent notable developments in bank regulation, touching on capital reform, the Community Reinvestment Act, the cap on debit card interchange fees, and climate-related financial risk guidance.[2] Today, I want to recap my views on some of these developments, particularly around bank mergers and acquisitions (M&A), liquidity regulation, and trends in bank supervision.

### Bank mergers and acquisitions

Bank mergers and acquisitions continue to be an important part of the banking ecosystem. In this process, timing is key. However, this is another policy area where I expect to see ongoing focus from federal regulators, the Department of Justice, and others. As policymakers engage on this topic, a key consideration should be whether the application process is fair, transparent, and consistent with the applicable statutory requirements.[3] And yet, policy reforms may make bank M&A transactions more difficult for regulators to approve and slow the application processing timeline.

As all bankers know, application processing delays can be quite harmful, resulting in greater operational risk, increased expenses due in part to contract delays, reputational risk, and staff attrition due to the prolonged uncertainty. In the broader context, reducing the efficiency of bank mergers and acquisitions may also act as a deterrent to a healthy evolution of the banking system. Taken together, reducing merger or acquisition activity could have the consequence of prohibiting transactions that may preserve the presence of banks in rural or underserved areas, transactions that may further prudent growth strategies, or transactions that may result in increased competition with larger peers.

Regulatory reforms in this area should prioritize speed and timeliness. Stakeholders who are concerned about current bank M&A procedures and policies should consider direct engagement with regulators.[4]

## Liquidity

Following the bank failures last spring, significant attention has been paid to the alleged "lessons learned" creating a path for regulatory reform efforts. This has generated discussion among both policymakers and the public on how to think about liquidity regulation: Should these requirements be expanded to a broader range of institutions? Should the calibration or operation of liquidity requirements like the Liquidity Coverage Ratio and Net Stable Funding Ratio be modified? Should we consider new liquidity requirements, and if so, what form should they take?

I have significant concerns about the path ahead as it comes to regulatory reforms involving liquidity requirements. All banks must manage their liquidity but should have flexibility based on a range of factors, including risk, business model, size, complexity, funding needs, vulnerability to deposit runs, and other considerations. Liquidity requirements, if not appropriately designed and calibrated, could trap resources that would otherwise be put to better use, like lending to bank customers. Before moving forward, we need to identify gaps in the current framework and build a foundation for any proposed changes that is based on research, evidence, and data.

Liquidity regulation also has the potential to impose significant costs and limit the lending capacity and business operations of banks, which we must recognize and take into account before imposing any new requirements.

We must think about liquidity broadly, including the sources and uses of liquidity that institutions use today, including the Federal Reserve's discount window and its role as lender of last resort, advances from the Federal Home Loan Banks, and other sources that may be available in the market. In this context, we must be honest about the capability and capacity of these resources, and the challenges and limits of these tools.

Revisions to the liquidity framework must also be coordinated to ensure that reform efforts are complementary and can support the banking system's liquidity needs. When considering new liquidity requirements, we must think about not only calibration and scope, but also the unintended consequences of any such requirements and whether these measures will be effective during stressed conditions.

### Trends in supervision

During 2023 and into 2024, many banks reported very material shifts in bank examinations and ongoing intensification 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 or can disrupt the management and operations of affected banks.

These changes largely occurred after the bank failures in the spring of 2023 and the ensuing banking stress. In part, the changes in supervisory practices may be attributable to flawed post-mortem reviews conducted in the immediate aftermath of these 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. These trends in supervision are concerning and add to the already significant burdens placed on regulated institutions from an aggressive regulatory reform agenda. I worry that the mere fact of bank failures and the material banking stress we experienced last year has been interpreted as a "blank check" to remake supervision as a blunt instrument, one that ignores the unique characteristics of each firm and the benefits of an approach that prioritizes engagement and communication between banks and examiners.

Of course, the banking agencies cannot regulate our way to better or more effective supervision; in the aftermath of the banking stress, it is appropriate to look carefully at what is working, and what isn't, in the realm of bank supervision. But in doing so, 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. Conducting supervision in a manner that respects due process and provides transparency around supervisory expectations can help us accomplish these goals.

## Closing Thoughts

Thank you again for the opportunity to speak with you today. We are experiencing significant changes in the banking industry, not least of which are those coming from the regulators. It is imperative that you continue engaging on all matters involving regulatory reform. Policymakers cannot fulfill the responsibility of promoting a safe and sound banking system if we ignore efficiency, tailoring, and appropriate calibration of

requirements in the reform agenda. These tenets should be central to the reform process. I welcome your insight on what is working, what is not, and the real-world consequences of regulations and regulatory reform efforts. Your input helps us ensure that the bank regulatory framework supports safety and soundness in an efficient and fair way.

Thank you for your continued engagement, and I look forward to our conversation.

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

[2] See Michelle W. Bowman, "Reflections on the Economy and Bank Regulation (PDF)" (speech at the Florida Bankers Association Leadership Luncheon Events, Miami, FL, February 27, 2024).

[3] See, e.g., Office of the Comptroller of the Currency (OCC), "Business Combinations Under the Bank Merger Act: Notice of Proposed Rulemaking," OCC Bulletin 2024-4, January 29, 2024.

[4] One avenue by which interested parties can provide feedback is through the recently launched mandatory review of regulatory burdens under the Economic Growth and Regulatory Paperwork Reduction Act of 1996. See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and OCC, "Federal Bank Regulatory Agencies Seek Comment on Interagency Effort to Reduce Regulatory Burden," joint news release, February 6, 2024; and "Statement of Michelle W. Bowman on the Review of the Board's Regulations under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA)," February 6, 2024.