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Brief Remarks on the Economy and Insights from Past Bank Regulatory Reform Efforts

by

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at

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It is a pleasure to be with you here today.[1] As a former community banker and a former state bank commissioner, I bring a unique perspective to my service on the Board of Governors of the Federal Reserve System. These different experiences help inform my views on the Fed's important role in bank regulation and supervision. Over the past five years, I have found that one of the most informative, enjoyable, and productive aspects of my work at the Fed is hearing from bankers about issues that are important to you, and that affect you and your customers. This includes, of course, the impact of the Fed's regulation and supervision. So today, I would like to share some thoughts about that and, should changes to the bank regulatory framework be necessary, how we can support thoughtful and considered changes.

Before we turn to our conversation, I'd like to offer a few thoughts on the economy and monetary policy, in light of our Federal Open Market Committee (FOMC) meeting last month. As you know, at that meeting, my colleagues and I voted to maintain the target range for the federal funds rate at 5¼ to 5½ percent, after raising rates sharply over the past year and a half to reduce inflation. Since then, there has been considerable progress on lowering inflation, and the FOMC has responded this year with a more gradual pace of increases. In keeping with this approach, we held the policy rate steady in June, raised it by 25 basis points in July, and then held steady again last month. Inflation continues to be too high, and I expect it will likely be appropriate for the Committee to raise rates further and hold them at a restrictive level for some time to return inflation to our 2 percent goal in a timely way.

[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.

Most recently, the latest inflation reading based on the personal consumption expenditure (PCE) index showed that overall inflation rose, responding in part to higher oil prices. I see a continued risk that high energy prices could reverse some of the progress we have seen on inflation in recent months.

At the same time, the economy has remained strong as the FOMC has tightened monetary policy. Real gross domestic product (GDP) has been growing at a solid pace. Consumer spending has remained robust, and the housing sector appears to be continuing to rebound. The most recent employment report showed a labor market with solid job gains. The average pace of job gains over the past year has slowed somewhat and the labor force participation rate has also improved over the same time frame, a sign that labor market supply and demand may be coming into better balance.

The banking system continues to be strong and resilient. Banks have tightened lending standards due to higher interest rates and funding costs and in anticipation of future regulatory requirements. But despite this tightening of lending standards, there has not been a sharp contraction in credit that would significantly slow economic activity. Bank loan balance growth has slowed, but ongoing strong household and business balance sheets combined with the growing importance of nonbank lending suggest that monetary policy may have smaller effects on bank lending and the economy than in the past.

Given the mixed data releases recently—strong spending data but a decline in inflation and downward revisions to jobs created in previous months—I supported the FOMC's decision to maintain the target range for the federal funds rate. Since then, the GDP and employment data have also been revised. The frequency and scope of recent

data revisions complicates the task of projecting how the economy will evolve. But I continue to expect that further policy tightening will likely be needed to return inflation to 2 percent in a timely way. The Summary of Economic Projections released in connection with the September FOMC meeting showed that the median participant expects inflation to stay above 2 percent at least until the end of 2025. This, along with my own expectation that progress on inflation is likely to be slow given the current level of monetary policy restraint, suggests that further policy tightening will be needed to bring inflation down in a sustainable and timely manner.

It is important to note that monetary policy is not on a pre-set course. My colleagues and I will make our decisions based on the incoming data and its implications for the economic outlook. I remain willing to support raising the federal funds rate at a future meeting if the incoming data indicates that progress on inflation has stalled or is too slow to bring inflation to 2 percent in a timely way. Returning inflation to the FOMC's 2 percent goal is necessary to achieve a sustainably strong labor market and an economy that works for everyone.

I would now like to share some views on how I see a responsible evolution of the bank regulatory framework in my day-to-day work on the Board. To frame this discussion, I would like to revisit a few of the regulatory actions the Board has engaged in over the past year. I will identify several lessons we can learn from these actions and consider how we can apply these lessons when thinking about ongoing and future reforms to the bank regulatory framework.

Specifically, I would like to address three broad themes: (1) how efficiency should be a key factor in policy discussions, (2) how to think about limits on the Board's

tools to implement policy decisions, and (3) the importance of due process and public engagement in rulemaking.

Efficiency should play a central role in policymaking. Policymakers should consider how a desired policy goal can be achieved in a targeted manner that minimizes costs and administrative burdens on financial institutions. In June of this year, the Board, along with the FDIC and OCC, released third-party risk management guidance for banks of all sizes. While I continue to support the overarching and worthy goal of the guidance, as I noted at the time, I think the agencies lost an opportunity to maximize efficiency in the release of this guidance. The text acknowledged the *need* for resources to assist community banks in meeting the untailored expectations set forth in the guidance, but failed to *provide* those resources on a timeline that would have improved transparency and understanding among community banks. In the absence of clearly defined expectations, the regulatory agencies should have supplemented the published guidance to ensure that the smallest banks understand how to apply the guidance to their third-party relationships.[2] Over the years, the bank regulatory agencies have made great efforts to enhance our approach to consider financial institution risk, business model, and asset size in our regulatory proposals and guidance. This guidance did not meet that bar, and we should do better for the smallest in size, yet largest number, of banks.

The benefits of an efficient approach extend well beyond rulemaking and guidance and apply broadly to all aspects of the Federal Reserve's approach. For

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[2] "Statement on Third-Party Risk Management Guidance by Governor Michelle W. Bowman," (June 6, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230606.htm. ("The guidance contemplates that the agencies plan to develop additional resources to assist smaller, non-complex community banks in managing relevant third-party risks, but provides no timeline for development of these resources. It also makes clear that these additional resources will not be available for some time. This leaves one to wonder why the rush to publish without appropriate tools available for small banks.")

example, as I noted at the St. Louis Reserve Bank Community Banking Conference earlier this week, delays in processing applications can be harmful to banks of all sizes. The Board's application review processes should support the efficient resolution of applications.[3] One way the Board could do this is by improving the approach to processing applications in cases where a member of the public has made an adverse comment. When the recent supervisory record addresses the concerns raised in the protest and the record is consistent with approval, the decision should be delegated to the Reserve Bank for a determination.[4] Our goal should be to ensure that bona fide concerns raised by the public are appropriately considered, without resulting in unnecessary processing delays.[5]

Another important issue relates to how policymakers should consider the limits on available regulatory tools. Before the Board uses its regulatory or supervisory authority, we need to ask a basic question: Does the Board have the legal authority to use the tool in the manner contemplated? Late last year, the Board published principles for climate-related financial risk management for large financial institutions for public comment.[6] While I supported publishing the draft principles, I noted at the time that the Board "has specific responsibilities, established by Congress, to supervise holding companies and

[3] Michelle W. Bowman, "The Role of Research, Data, and Analysis in Banking Reforms" (speech at the 2023 Community Banking Research Conference sponsored by the Federal Reserve System, the Conference of State Bank Supervisors, and the Federal Deposit Insurance Corporation, October 4, 2023), https://www.federalreserve.gov/newsevents/speech/bowman20231004a.htm.
[4] See "Statement on Application by Vantage Bank Texas by Governor Michelle W. Bowman," (June 27, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230627.htm.
[5] See Michelle W. Bowman, "Independence, Predictability, and Tailoring in Banking Regulation and Supervision" (speech at the American Bankers Association Community Banking Conference, February 13, 2023), https://www.federalreserve.gov/newsevents/speech/files/bowman20230213a.pdf.
[6] Board of Governors of the Federal Reserve System, "Federal Reserve Board Invites Public Comment on Proposed Principles Providing a High-Level Framework for the Safe and Sound Management of Exposures to Climate-Related Financial Risks for Large Banking Organizations," news release, December 2, 2022, https://www.federalreserve.gov/newsevents/pressreleases/other20221202b.htm.

banks, with a focus on the safety and soundness of these regulated institutions."[7] Of course, any decision to mandate guidance on a narrow area like climate-related financial risk—highlighting this one risk out of the full range of risks that banks manage today—should be based on evidence of unique climate financial risks and an identified need for more guidance addressing this area. Of course, any new guidance should complement existing standards as well. As I observed at the time the climate guidance was proposed, "[t]he new principles contemplate additional obligations on firms to monitor and measure a broader set of climate-related risks, over indefinite time horizons."[8] Such narrow and specific guidance runs the risk of going beyond the scope of safety and soundness, by focusing on narrow, remote and uncertain risks with minimal demonstrated impacts on financial institutions. I am concerned that the Board could unintentionally interfere with the ability of a bank's management to make credit allocation decisions. Under no circumstances should the Board mandate credit allocation decisions for banks—directly through a prohibition, or indirectly through policy tools like guidance—and we must carefully evaluate this type of guidance with an eye toward whether the policy tool we use is appropriate in the circumstance.

Another example I want to highlight is the use of conditions in applications. In the process of deliberating on applications that come before the Board, the Board can impose limitations or restrictions in certain circumstances, to address specific supervisory or policy concerns raised by the application. While this can be an important tool, it cannot replace rulemaking.

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[7] "Statement by Governor Bowman on Principles for Climate-Related Financial Risk Management for Large Financial Institutions," (December 2, 2022), https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20221202.htm.
[8] See footnote 7.

In a Board Order approving a large bank application last year, the Board used its commitment authority in a way that "could impose heightened prudential standards at a fixed date in the future" on a firm, in a manner "inconsistent with the Board's existing regulatory framework, which imposes tailored requirements based on clear, quantitative measures of the firm's underlying risk."[9] This Board action highlights yet another question policymakers should ask when using one of many bank regulatory and supervisory tools, namely whether the tool is appropriate in the circumstances, or whether another tool—one established by regulation to address the very concern raised—is more appropriate.[10] The Board's rules and regulations are often the most appropriate and effective tools to address supervisory and financial stability concerns.

Finally, I want to talk about how due process and promoting public engagement can improve the rulemaking process, including by helping policymakers understand the impact of proposed rules. In October of last year, the agencies finalized amendments to the Board's Regulation II, implementing new rules pertaining to debit card routing on different networks. During the public comment process, community banks raised substantial concerns with the proposal, specifically around the uncertainty of the rule revisions on fraud and the cost of compliance. As a result of comments raised, and my view that significant questions remained about the effect of the rule, I did not support the Board's final action.[11] But a key element in that rulemaking is that banks engaged in the

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[9] "Statement by Governor Bowman on Advance Notice of Proposed Rulemaking on Resolution Requirements for Large Banks and Application by U.S. Bancorp," (October 14, 2022), https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20221014.htm
[10] See footnote 9.
[11] "Statement on Final Amendments to Regulation II to Clarify the Prohibition on Network Exclusivity by Governor Michelle W. Bowman," (October 3, 2022), https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20221003.htm.

rulemaking process shared their feedback, especially around potential fraud concerns and the speed with which the rule mandated system changes and implementation without consideration of the practical implementation and processor functionality constraints.

Community banks have unique perspectives and concerns, and raising these issues with policymakers can make a difference in the contours of any final rules. In my conversations with state member banks over the past 12 months, many have shared their concerns about the proposed changes to the criteria for becoming or maintaining their designation as a certified community development financial institution (CDFI). While CDFI certification is the sole purview of the CDFI Fund within the Treasury Department, I appreciate the implications the recent proposed revisions to these guidelines may have on nearly 200 bank CDFIs and the communities they serve. But this also shows the opportunity, and the need, for the robust public engagement of affected stakeholders.

From time to time, my colleagues and I disagree on policy questions. But, the rulemaking process benefits when policymakers have the full scope of information needed to inform our discussions and debate. This enables us to fully appreciate the actual impact of our policy decisions.

The rulemaking process provides a path for policymakers to follow that is designed to ensure that we are aware of the important tradeoffs and considerations in understanding the intended and unintended consequences resulting from each proposal.

Conclusion

I would like to conclude by emphasizing the critical role you and other public commenters play in making the rulemaking process work as it was intended. This is a

topic I have frequently raised, which is the importance of robust public engagement on the Federal Reserve's and the other federal banking agencies' rulemaking agendas.

A number of rules have been proposed for comment or are currently in the pipeline. Some have already been published, including the proposal to implement Basel III "endgame" by significantly expanding capital requirements and bringing the threshold for compliance down to include *all banks* over $100 billion in assets *from only the largest* banks, and the expansion of the long-term debt requirement from *only the largest banks again* to *all banks* over $100 billion in assets. Still other proposals have not yet been published or moved to the next stage of the rulemaking process, including the Community Reinvestment Act rulemaking, the further consideration of climate guidance, and others. The Board has also publicly indicated it may propose additional revisions in the future to Regulation II.

The scope of some of these reforms will be extensive and could reshape the contours of the bank regulatory framework, including for community banks, and could restrict the ability of consumers and businesses to access credit and other financial services from chartered financial institutions. It is critical that stakeholders engage in the comment process and communicate with policymakers to share their views on the rulemaking agenda, including the specific impacts—intended and unintended—of any changes. Public comments, data, and analysis help to inform decisions made throughout the rulemaking and proposal process. The bankers in this room and across the country are vitally important to the banking system, and to the broader economy. As reforms take shape, it is important that we incorporate your perspectives on the real-world consequences of any considered changes.

I look forward to our conversation.