For release on delivery
10:30 a.m. EDT (8:30 a.m. MDT)
October 2, 2023

Brief Remarks on the Economy and Bank Regulation

by

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at

The CEO/Executive Management Conference
Sponsored by the Mississippi Bankers Association and the
Tennessee Bankers Association

Banff, Canada

October 2, 2023

Thank you for the invitation to join you today. It is a privilege to speak to so many bank leaders from Mississippi and Tennessee together at the same time, and I appreciate the opportunity to be here with you.[1] As a former community banker, one of the most informative, enjoyable, and productive aspects of my role is the time I spend with community bankers, listening to issues that are important to you and that affect you and your customers, including, of course, the impact of the Fed's regulation and supervision. Community banks play a key role in supporting economic growth and lending to serve their customers and communities, which is an indispensable role in the U.S. economy.

Before we turn to our conversation, I'd like to offer a few thoughts on the economy and monetary policy, following 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 non-bank lending suggest that monetary policy may have smaller effects on bank lending and the economy than in the past.

Given the mixed data releases—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 data have also been revised. The frequency and scope of recent data revision complicates the

task of projecting how the economy will evolve. But I continue to expect that further rate increases 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 also like to briefly discuss recent and future developments in banking regulation. The bank failures and accompanying banking system stress earlier this year made clear that the Federal Reserve, and in some cases the other federal banking agencies, need to address supervisory shortcomings and potentially consider revision of some failure-related bank regulations. I have previously noted my perspective on the path forward, that proposals should be (1) focused on remediating identified issues and shortcomings; (2) informed by data, analysis, and genuine debate and discussion among policymakers within each of the participating agencies; and (3) developed through a

transparent and open process that allows policymakers and the public to understand the context, data, and analysis underlying the proposed reforms. The process must also incorporate the opportunity to solicit meaningful public comment.

Today we have an opportunity to revisit the path of regulatory reform, starting with whether we have identified the relevant issues and shortcomings. There have been a number of reports discussing the root causes of the failure of Silicon Valley Bank (SVB), including just this past week, a report from the Board's Office of the Inspector General.

Collectively, these reports have provided some valuable insights into the bank failure, but in my view, much work remains to ensure we have identified all of the factors that contributed to the failure of SVB, and the subsequent failures of Signature Bank and First Republic, including the actions of regulators in the lead-up to and following the failures. While there is overlap between many of the findings in the reports published to-date, these reports have not reached entirely consistent conclusions.

One way to effectively identify and address these issues is to engage an independent third party to conduct a review. As I have said since shortly after the bank failures occurred, a third-party review should review and analyze a broader time period than the limited time periods covered to-date, including a broader range of topics and issues that are likely to identify further areas in need of reform. While this type of review would be an unusual step, it is appropriate where, as here, the existing limited reviews are driving the regulatory reform agenda, and where these bank failures have caused significant losses.

Put another way, the purpose of an independent third-party review would be to analyze the events surrounding the failure of these banks, so that we can fully understand

what led to the failures. This would be a logical next step in holding ourselves accountable. Before making conclusions about appropriate responses going forward to address causal issues, we need accurate, impartial, and thorough information to inform the debate about what specifically may be needed to fix any problems in our supervision and regulatory framework. While the Board has made some confidential supervisory information about SVB available to the public, an outside party has an inherent disadvantage in probing the events surrounding the failure of a bank—they do not have access to the full supervisory record, and they have no ability to conduct extensive staff interviews. The Board could easily put this criticism to rest simply by engaging an independent third party to prepare a more thorough and broadly scoped report and giving that party the necessary access to information.

Of course, the staff who prepared the internal reviews, both the review led by Vice Chair for Supervision Barr, and the recently prepared report of the Board's Office of the Inspector General, had greater capacity to review internal information and speak with staff. But both of these reports themselves acknowledge their limited scope, related to the time constraints and the nature of the specific questions probed.[2]

While the reports produced to-date have provided some insights, it is worth pausing and reflecting on whether we have our regulatory and supervisory priorities aligned with the most pressing needs demonstrated by recent events, and whether we are

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[2] As noted in Vice Chair for Supervision Michael Barr's review of the supervision and regulation of Silicon Valley Bank, "[the] report was written with the benefit of hindsight on the particular facts and circumstances that proved most relevant for SVB and SVBFG. The report was prepared in a compressed time frame from March 13, 2023, through April 28, 2023, and further work over a longer period could draw additional or different conclusions." Barr, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank*. As noted in the Material Loss Review of SVB, the objective of the report was to determine why SVB's failure resulted in a material loss to the Deposit Insurance Fund, and to assess the Federal Reserve's supervision of SVB from January 2018 through March 2023. Board of Governors of the Federal Reserve System, Evaluation Report 2023-SR-B-013 (September 25, 2023).

taking the right "lessons learned" from these events. As regulators continue to pursue further supervisory and regulatory reforms, we should also pause and reflect on whether these changes are appropriately calibrated and executed.

To be clear, supervisory priorities have already been influenced by the bank failures earlier this year. The trend seems to be that regulators are engaging in supervision with a more heavy-handed approach, focusing primarily on quarterly call report data in some cases without the benefit of direct engagement with the targeted financial institutions.

The Board has long found that information received outside of a regular examination may suggest the need to carefully consider whether bank ratings remain appropriate.[3] But when engaging in this type of off-cycle review, we should consider whether the process is appropriately calibrated, is transparent to the financial institution, and whether it provides the financial institution the ability to engage in meaningful dialogue and discussion with examiners. In my mind, bank data analysis that occurs exclusively in an off-site context prevents supervisors from leveraging important opportunities to engage with financial institutions to effectively deliver supervisory messages. It is entirely appropriate to express concern or engage in dialogue with management, or to gain a better understanding of a bank's strategic direction or risk management approach based on reported data. Financial results are key, but in the continuum of supervision, we should not forget the value of a broader based supervisory approach that uses all available tools and considers all relevant factors.

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[3] Federal Reserve SR Letter 99-17 (June 24, 1999).

We should also carefully consider whether our approach is appropriate in the moment: Are the federal banking agencies acting in a consistent manner in their bank supervisory activities? Are federal banking agencies coordinating appropriately with state banking agencies when reviewing state-chartered banks? And fundamentally, are supervisory decisions being driven by a comparison or horizontal review of differences among institutions that may have very different business activities and risk profiles? Are supervisors acting pro-cyclically, or overreacting to the events of March 2023? When agencies adopt a more adversarial approach to supervision, or apply standards that are disproportionate to risk, does that negatively impact a bank's ability and willingness to engage in open communication with their examiners?

Asking these questions can help us appropriately calibrate our revised approach to banking supervision and help us avoid reacting in a way that is disproportionate to an institution's risk to the banking system.

Before concluding my prepared remarks, I'd like to discuss the Federal Reserve's and the other Federal banking agencies' rulemaking agenda. A number of rules have been proposed for comment or are currently in the pipeline. Some have already been published for comment 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 GSIB 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 in important ways, including for community banks. 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, and it is important that as reforms take shape, we incorporate your perspectives on the real-world consequences of any considered reform.

I look forward to our conversation.