For release on delivery
9:00 a.m. EDT (8:00 a.m. CDT)
May 19, 2023

Considerations for Revisions to the Bank Regulatory Framework

Remarks by

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at

Texas Bankers Association
Annual Convention

San Antonio, Texas

May 19, 2023

It is a pleasure to be here with you today.[1] I am especially pleased to participate in this event focused on "Building Stronger Communities." As a former banker, former state bank commissioner, and a member of the Federal Reserve Board that theme really resonates with me. We all know that a safe, sound, and fair financial industry built upon the dual banking system is the foundation of strong and stable communities. All throughout this great nation, and the state of Texas, community and regional banks provide financial services and essential credit to assist families and businesses achieve their dreams.

Federal regulators, including the Federal Reserve, in partnership with state banking departments—like Commissioner Cooper and his team here in Texas—are responsible for ensuring that banks provide these services in accordance with consumer and safety and soundness laws. State bank regulators help to provide context and an understanding of the unique economic conditions that exist within Texas and within the different regions of the state. This context helps our supervisory teams at the Fed better understand the decisions that a bank's management might make in light of particular circumstances and market dynamics.

Today, I thought I would spend some time following up on a few topics that I have been speaking about recently that provide some insight into the roles of policymakers and regulators, but most importantly highlighting the critical role of bankers in facilitating a strong economy. I will begin with bank supervision and risk-tailored bank regulation, and how I think about tailoring in the context of the recent bank failures and ongoing discussions about regulatory reform. I will then talk about the benefits of ***nimble*** supervision and how that approach supports

[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.

a U.S. financial system with banks of all sizes in every community in every diverse region of this country.

And finally, I will address the importance of ensuring that both banks and examiners are well prepared and positioned for potential stress in the banking market. Most importantly, though, I want to emphasize the role of due process in the Federal Reserve's bank supervision. We should not be remotely analyzing your bank and downgrading your rating without communication and justification. Due process requires formal engagement between examiners and the bank. If our examiners believe there is a reason to be concerned with the condition of your institution, the examiners should notify you and engage directly with you to make sure that they have a clear understanding of all of the facts, and that any supervisory actions—including any discussion of ratings downgrades—are appropriate based on the unique facts and circumstances of the institution.

It's been a while since I've felt the need to say this to our state-chartered banks, but the time has come to renew this message today and to emphasize it going forward. I'm sure you are not surprised that our largest bank CEOs do not hesitate to engage directly with the Board and Reserve Bank presidents. I see one of my many functions and roles as a Member of the Board of Governors as providing that open door and opportunity for direct engagement with a policymaker for our regional and smaller banks, as well. Your Texas ABA executive, Chris Furlow, who is a long time friend and colleague, can put you directly in touch with me should you desire to do so. As a former banker, and bank commissioner, I know from experience that building a relationship is key to effective communication. And it's always better to have made that connection before you need it. I look forward to that opportunity to get to know each of you.

Tailored Supervision and Regulation, and the Path Forward for Reform

As every banker in this room knows, tailoring is a critical aspect of the federal regulatory and supervisory framework. It has continued to be a core principle in strengthening bank oversight since the 2008 financial crisis. Over the years, as regulators refined and improved the regulatory and supervisory framework, the concept of tailoring has evolved. Overseeing banks based on their size, risk, business model, and complexity provides appropriate proportionality to our work.

I've often said that risk-based supervision is itself a form of tailoring.[2] This approach to supervision and regulation, when it works effectively, allows us to focus supervisory attention on areas that pose the greatest risk. It also recommends differences in regulatory requirements and supervisory expectations, based on the size and complexity of the bank. It is simply common sense that what works well for the largest global systemically important banks (G-SIBs) is not appropriate for regional and community banks. Our tailored approach applies across many areas, including in the stringency and complexity of capital requirements and for regulatory reporting obligations.

As regulators consider the appropriate response to the recent bank failures, a renewed focus on the role of tailoring has emerged. From my perspective, there are several important steps we must take. First, we must seriously consider the feedback from a variety of internal and external viewpoints to identify what went wrong. In my view, one of the most effective steps the

[2] 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.

Federal Reserve could take would be to engage an independent third party to analyze the events surrounding the failure of these banks, so that we can fully understand what led to the failures. 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.

Second, supervisors must do a better job of focusing on and identifying key issues and risks to ensure they can be promptly remediated. It is imperative that bank management, the board of directors, and supervisors understand bank business models, and risks that may emerge to threaten that model. Where issues are identified, supervisors need to clearly explain the concerns, so that bank management can create a plan to address them. Regulators already have a comprehensive toolkit at their disposal to encourage issue resolution, and frankly, we need to use those tools appropriately, not create more tools because we failed to use the tools at our disposal.

To be sure, we do need to consider whether there are necessary, appropriate adjustments to improve the bank regulatory and supervisory framework. But our focus in doing so must be concentrated on identified problems and risks with clearly defined goals and outcomes. We should avoid using these bank failures as a pretext to push for other, unrelated changes to bank regulation. But, as we engage in this exercise, I think we need to carefully consider both the strength of the current regulatory framework and the effective implementation of tailored supervision.

On this last issue—as we consider making changes—we need to carefully consider how these proposals will incorporate tailoring of regulation and supervision—specifically when considering reforms.

Are we in the same place today as we were at the onset of the 2008 financial crisis? Of course not. While we have seen stress in some parts of the banking system, overall the system is strong and resilient. U.S. banks have high levels of capital and liquidity, and banks of all sizes continue to support the economy. To a large degree, this strength comes from the work done at the direction of Congress, most recently pursuant to the bipartisan Economic Growth, Regulatory Relief, and Consumer Protection Act, which better aligned regulation with risk.[3] The strong set of laws and regulations we have today suggests that the problems in the banking system require a targeted solution, one focused on actual risks, on improvement of supervision and risk management, and on prompt remediation of supervisory issues.

Not only is the current tailoring approach robust, it also results in efficiency. Tailoring distinguishes firms by size, risk, and complexity, and imposes appropriate regulatory requirements in light of these differences. The Board considers a number of factors when evaluating the largest firms, including size, cross-jurisdictional activity, reliance on short-term wholesale funding, off-balance sheet exposures, and nonbank assets. These characteristics, and the G-SIB scoring methodology more broadly, help distinguish the largest firms that pose the greatest risks from smaller and less systemic firms. Even for smaller firms, we have clear regulatory standards and thresholds to ensure that supervision is appropriately tailored for each institution. This framework provides appropriate scale for both regulators and for banks. It strikes the crucial balance between safety and soundness and ensuring that well-supervised and regulated banks are able to continue providing credit to their local and regional businesses and communities.

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

Fundamentally, we should be careful not to undermine tailoring and risk-based supervision. While there were some clear lapses in the supervision of Silicon Valley Bank, our Fed supervisors and those with the other banking agencies are dedicated public servants who I am confident will embrace the lessons learned from the recent bank failures. We need to provide examiners with direction and support to promote safety and soundness in the banking system. The banks that recently failed were unique in their operations and business models. These failures alone do not justify layering on inefficient and overly complex supervision on a broad range of other banks.

Nimble Supervision

One reasonable expectation from the many reviews of the recent bank failures will likely be an analysis of and recommendation for changes in supervision. How do we prioritize these issues for improving risk-based supervision? How do we revise those priorities when underlying economic conditions evolve or banks begin to engage in new activities that present new risks? We will need to be sure that whatever approach we adopt, we devote sufficient supervisory attention to the areas of highest risk, while not hindering innovation.

As I've briefly discussed today, we need to have a supervisory system that focuses appropriate attention on the traditional risks that are inherent to the business of banking: credit, liquidity, concentration, and interest rate risk. Historically, supervision has been an effective tool to address these traditional risks. Supervisors can make sure that banks are working to mitigate such risks with effective risk management and liquidity planning.

As we consider changes to our framework, we need to understand potential unintended consequences and be mindful that we do not inhibit innovation so that banks remain competitive and well positioned to effectively serve the needs of their customers.

It will continue to be a challenge to ensure the appropriate focus on traditional banking risks while encouraging innovation. But it can be accomplished if we approach it from the need for transparency, transparency by banks about their innovation activities and agenda, and transparency by regulators regarding supervisory expectations and emerging risks. Transparency can help us promote these dual objectives, maintaining a focus on traditional risks, while enabling banks to innovate in a safe and sound manner, with a clear understanding of our expectations. At the same time, failure to adopt a transparent approach can lead to adverse consequences for consumers, businesses, and communities by limiting banking products and services and pushing activities outside of the regulated banking system. We need to preserve regulatory support for innovation conducted safely and soundly consistent with applicable laws, including consumer protection.

Promoting Bank Readiness

Voices calling for broad, fundamental reforms of the U.S. banking system appear to advocate a shift away from tailoring and risk-based supervision. The view that we extend the reach of overly complex and outsized regulatory requirements to banks that are smaller and less complex ignores some likely results—doing so will lead to bank consolidation, and will potentially push banking activities outside of the regulated banking system. This could also lead to the elimination of all but the largest too-big-to-fail banks who would then be insulated from other competition. This is surely not the outcome that supporters of the 2008 financials crisis reforms were seeking.

It is also, in my mind, not the right approach. In a time of potential stress, we need to be forward focused on bank preparedness so that banks are positioned to address issues of concern. These include being prepared to address contingency funding needs, with a plan in place that has

been tested and is ready to be executed. Regulators need to be supportive of this kind of planning. One of the preliminary lessons learned from the recent bank failures is that bank management, and their boards of directors, should be prepared to test the banks' ability to manage liquidity needs during times of stress.

This is one area where I think bankers can make an important, immediate contribution. I strongly encourage bankers to consider creating a plan to handle liquidity needs during times of unexpected stress—and then test the ability to execute the plans. Adverse conditions can escalate quickly, and influences beyond a bank management's control, including irrational actors, can impact your business in very short order. For example, we know that a number of banks have not registered for or accessed the Federal Reserve's discount window.

But if the bank plans include accessing discount window lending—even if the likelihood of that stress is extremely remote—it is critical to understand in advance the steps needed to be taken during the emergency. This could include testing the capacity to pledge collateral or even just contacting your local Reserve Bank to learn about or complete the necessary onboarding procedures.

The Path Forward

My views on the path forward are informed by serving as the bank commissioner for the state of Kansas as its lead regulator and supervisor, my experience as a banker, and especially by my service on the Board of Governors since 2018, during a time when the banking system has experienced many unique stresses including those associated with the COVID pandemic. There have already been some preliminary and expedited internal reports published on the failures of SVB and Signature Bank, and I fully expect to see additional reports and analysis of these

failures, and the failure of First Republic, in the coming months.[4] These preliminary reviews are an important first step for the U.S. bank regulators working to identify root causes of these bank failures and holding themselves accountable for supervisory mistakes. There are additional steps that we can take.

First, I believe that the Federal Reserve should engage an independent third party to prepare a report to supplement the limited internal review to fully understand the failure of SVB. This would be a logical next step in holding ourselves accountable and would help to eliminate the doubts that may naturally accompany any self-assessment prepared and reviewed by a single member of the Board of Governors.[5] This external independent report should also cover a broader time period, including the events of the weekend following the failure of SVB, and a broader range of topics beyond just the regulatory and supervisory framework that applied to SVB, including operational issues, if any, with discount window lending, Fedwire services, and with the transfer of collateral from the Federal Home Loan Banks.

Second, I believe we need to do a better job identifying the most critical issues and moving quickly to remediate them. It is evident that both supervisors and bank management neglected key, long-standing risk factors that should be an area of focus in any examination. These include concentration risk, liquidity risk, and interest rate risk. We have the tools to

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[4] See Government Accountability Office, "Bank Regulation: Preliminary Review of Agency Actions Related to March 2023 Bank Failures" GAO-23-106736 (Washington: Government Accountability Office, April 2023), https://www.gao.gov/assets/gao-23-106736.pdf; Federal Deposit Insurance Corporation, "FDIC's Supervision of Signature Bank" (Washington: Federal Deposit Insurance Corporation, April 28, 2023), https://www.fdic.gov/news/press-releases/2023/pr23033a.pdf; Michael Barr, Vice Chair for Supervision of the Board of Governors of the Federal Reserve System, "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank" (April 28, 2023), https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.

[5] 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*.

address these issues, but we need to ensure that examiners focus on these core risks and are not distracted by novel activity or concepts.

Finally, we should consider whether there are necessary—and targeted—adjustments we should make to banking regulation. This will likely include a broad range of topics, including taking a close look at deposit insurance reform, the treatment of uninsured deposits, and a reconsideration of current deposit insurance limits.[6] We should avoid using these bank failures as a pretext to push for other, unrelated changes to banking regulation. Our focus should be on remediating known, identified issues with bank supervision and issues that emerge from the public autopsy of these events.

A debate about regulatory changes must also consider where we are today as compared to prior to the 2008 financial crisis. The banking system is strong and resilient despite recent banking stress. The Fed has refined regulatory standards over time at the direction of Congress, and through the "tailoring" regulations I discussed earlier that are designed to better align regulation with risk.[7] Even with the implementation of these changes, banks today are better capitalized, with more liquidity, and are subject to a new range of supervisory tools that did not exist prior to 2008. This banking system is not only strong today but is well prepared to continue supporting the provision of credit and the broader economy.

Radical reform of the bank regulatory framework—as opposed to targeted changes to address identified root causes of banking system stress—is incompatible with the fundamental strength of the banking system. I am extremely concerned about calls for casting aside tiering

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[6] See Federal Deposit Insurance Corporation, "Options for Deposit Insurance Reform" (Washington: Federal Deposit Insurance Corporation, May 1, 2023), https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf.

[7] Economic Growth, Regulatory Relief, and Consumer Protection Act, Public Law No. 115-174, 132 Stat. 1296 (2018).

expectations for less complex institutions, given the clear statutory direction to provide for appropriately calibrated requirements for these banks.

I have also heard calls for broad, fundamental reforms for the past several years, shifting away from tailoring and risk-based supervision. I believe this is the wrong direction for any conversation about banking reform. The unique nature and business models of the banks that recently failed, in my view, do not justify imposing new, overly complex regulatory and supervisory expectations on a broad range of banks. If we allow this to occur, we will end up with a system of significantly fewer banks serving significantly fewer customers. Those who will likely bear the burden of this new banking system are those at the lower end of the economic spectrum, both individuals and businesses.

The American economy relies on a broad and diverse range of businesses supported by a broad and diverse range of banks. Eliminating regional banks from the U.S. banking system would be devastating to businesses and communities across America. Especially in those regions whose communities are not sufficiently served by larger institutions.

As I conclude, I want to reiterate that the banking system remains strong and resilient, and that bankers across Texas, and the United States, are deeply engaged in their work to support and build their local businesses and communities. It is imperative that going forward policymakers preserve a framework that supports a diverse and dynamic banking sector, with banks of all sizes that serve the needs of their unique customers wherever they are located.

Thank you for the opportunity to speak with you today.