For release on delivery
5:00 p.m. EST (12:00 p.m. HST)
February 2, 2024

# The Future of Banking

Remarks by

Michelle W. Bowman

Member

Board of Governors of the Federal Reserve System

at

The 157th Assembly for Bank Directors,
Southwestern Graduate School of Banking

Maui, Hawaii

February 2, 2024

Thank you for the invitation to join you today at the Southwestern Graduate School of Banking's 157th Assembly for Bank Directors.[1] In light of the recent direction of public policy affecting the financial system and bank regulation, my remarks today will discuss the potential impact of this current approach on the long-term future of banking. Too often, when we think about the future of banking, we focus only on today's most pressing issues and problems, some of which will be fleeting and may not have long-term impacts on the banking system. So today, I would like to take a higher-level view to think about the future of banking over a longer time horizon. My framing will focus on how the past can shed some light on the dynamics that bank leadership must consider in running their banks and that regulators should consider as we regulate and supervise institutions. My hope is that this broader perspective can help to provide bank directors—and even regulators—with some perspective on how today's choices may shape the banking system.

Before I delve into the "future" of banking, I want to spend a moment on the "present" of monetary policy and the economy.

At our meeting earlier this week, the Federal Open Market Committee (FOMC) kept 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 readings over the past six months indicate that the Committee's past policy actions are having the intended effect of reducing inflationary pressures. The most recent 12-month readings through December for total and core personal consumption expenditures (PCE) inflation came in at 2.6 and 2.9 percent respectively, the first time both measures have been below 3 percent since the spring of 2021. I view the slowdown in inflation readings over recent months as encouraging. In addition to this progress on inflation, economic

[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.

activity has continued to expand at a strong pace while the labor market has remained tight. Further evidence of economic strength showed in the advance report of fourth quarter real gross domestic product (GDP) with an increase of 3.3 percent, partly reflecting ongoing strength in consumer spending, and also in today's employment report with an acceleration in job gains to a very strong pace of around 350,000 for both December and January. The unemployment rate remained low at 3.7 percent. This appears to reverse the trend from last year, when the average pace of job gains slowed and the labor force participation rate rose through November, a sign that labor market demand and supply may have been coming into better balance. That said, today's jobs report with markedly stronger job growth and a labor force participation that has retraced some of its earlier gains suggests that progress has stalled over the past two months.

Considering these developments, 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. My baseline outlook is that inflation will decline further with the policy rate held at the current level. 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. And a number of important upside inflation risks remain.

These include risks from geopolitical conditions, including the prominent 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 continued easing in financial conditions could add momentum to demand, stalling any further 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. Today's labor market data, which indicated a pickup in wage inflation in recent months, suggests ongoing elevated wage growth as some businesses continue to report above-average wage increases to compensate for inflation.

Given these risks, and the general uncertainty regarding the economic outlook, I will continue to watch the data closely—especially the inflation data revisions next week and upcoming inflation reports—as I assess the appropriate path of monetary policy. The frequency and extent of data revisions over the past few years, as illustrated in today's employment report, make the task of 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. Reducing our policy rate too soon could result in requiring further future policy rate increases to return inflation to 2 percent in 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 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 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.

## The Future of Banking

Turning back to the future of banking, today we find ourselves at an interesting juncture in the evolution of the banking system. Some traditional risks—like interest rate risk and liquidity risk—have become a higher priority concern for banks and regulators, while other risks—like cybersecurity and fraud—continue to evolve and pose challenges. And of course, banking regulation and proposed reforms exert pressure on important elements of the banking system, affecting both the size and activities of banks. At the same time, I see important opportunities—and a critical need—for banks to continue supporting their communities and to find new and innovative ways to deliver financial products and services.

Bankers and regulators alike must think about these dynamics and how they will impact the future of the banking system, including safety and soundness, U.S. financial stability, the future role of banks in the U.S. financial system, and how our actions today could have long-term consequences.

### *The Risk of Complacency*

Banks have an obligation to manage all material risks, and yet we see that even with traditional risks—interest rate and liquidity risk, for example—long periods of calm, such as those that followed the prolonged period of low interest rates following the 2008 financial crisis, can lull both bankers and regulators into a state of complacency.

Often, this complacency stems from false assumptions, assumptions that prove to be inaccurate over time. For example, leading up to the 2008 financial crisis there was an unrealistic expectation that housing values would continue to appreciate. Those who relied on this expectation made choices that proved to be ill-advised in the long run resulting in severe economic consequences. Likewise, the persistently low interest rates that were a legacy of the post-2008 financial crisis period led some to chase yield in their securities investment portfolios, over-investing in fixed-rate, long-term securities relying on the belief that long-term interest rates would remain low in perpetuity. Regulators themselves—while increasingly aware of and focused on these risks over time—were late to the game in terms of taking strong, proactive action, both in the lead-up to the 2008 financial crisis, and more recently, in the lead-up to the banking stress in the spring of 2023.

In each of these cases, false assumptions led to complacency, which resulted in an inability to appropriately recognize and appreciate the early signs of risk that ultimately stressed the banking system and the broader economy. But how do we protect the banking system against the risks that come from complacency? For bankers, I think this requires a constant focus on risks, both traditional and emerging. To be clear, many bankers live with this mindset every day; they know their borrowers and communities, and they carefully monitor traditional and emerging risks—and manage those risks—on an ongoing basis.

In many ways, complacency can result in overlooking risks even on matters that are universal in the management of all banks, like succession planning and information technology management. We know that many banks, particularly those in rural markets, face significant challenges when planning effective leadership succession. Absent appropriate succession planning, often the only options for a bank can be a sale to a competitor or ceasing operations, both of which can harm the bank's local community. Even the management of information technology can pose significant risks if a bank fails to devote sufficient resources to maintaining and updating systems, or if a bank fails to appropriately integrate and update legacy systems, such as after a bank acquisition or merger.[2]

For regulators, the cure for complacency is consistent attention even to dormant risks, and an appropriately robust response when issues are identified. Complacency is not always the

[2] Notably, information technology issues continue to be one of the most frequently cited findings in supervisory examinations of regional banking organizations and community banking organizations. See Board of Governors of the Federal Reserve System, *Supervision and Regulation Report* (Washington: Board of Governors, November 2023), https://www.federalreserve.gov/publications/files/202311-supervision-and-regulation-report.pdf, figure 16, "Outstanding supervisory findings by category, CBO firms," and figure 17, "Outstanding supervisory findings by category, RBO firms."

product of inattention but can also arise because of mis-prioritization, such as when regulators focus on risks that are tangential to statutory mandates and critical areas of responsibility. This kind of misprioritization can increase the risk that regulators overlook areas that require more immediate attention.

Sometimes, familiar risks emerge in new ways. Having a concentrated, monoline business model and experiencing rapid growth are both well-known risks to ongoing viability, even though the particulars may vary over time. During the banking stress in 2023, several banks that experienced particularly acute stress had concentrated exposures or monoline business models, for example, with a heavy exposure to customers in the crypto-asset industry.

The cyclical nature of regulatory issues itself presents a challenge for regulators. Over time, examiner attrition and retirements that come along with an aging workforce erode institutional knowledge, expertise, and experience, making it more difficult to maintain an appropriate focus on longstanding risks.

As we look to the future of banking, we should consider the dynamic nature of the banking system and know that we must be assertive in identifying known and emerging risks, and nimble in responding to them, keeping in mind that risks that appear to be extinct may only be hibernating.

### *Banking Changes Bring New Risks*

Of course, even with a relentless focus on the known risks that affect the banking system—credit risk, interest rate risk, liquidity risk, cyber risk, and others—we also know that as the banking system evolves, the risks evolve as well. Even though change in the banking system is constant, many banking services have stayed relatively similar over time. The use of paper checks, while helpful to consumers in many ways, have re-emerged as a source of increased fraud risk. The advent of the automated teller machine (ATM) and electronic banking opened up new avenues for banks to bring convenience and access to their customers, but also gave criminals new opportunities to attack the banking infrastructure. Even the legal and regulatory changes that allowed interstate banking to flourish fundamentally altered the composition of the banking sector, bringing both greater efficiencies of scale as banks took advantage of opportunities to consolidate, but also putting pressure on some banking models—and perhaps perversely resulting in less availability of local banking options in some geographic and socioeconomic areas.

Of course, recent changes provide consumers with enhanced options for services, including improvements to the U.S. payment system. Recent enhancements in real-time payments services have made them more widely available. But with this growth comes additional risk, including limitations on the ability to detect and prevent fraud. Banks also increasingly rely on important relationships with third parties, including service providers and partners who provide services to customers through "banking-as-a-service" arrangements. As third-party relationships continue to play an increasingly critical role in the banking system, they present another new avenue for risks that must be managed.

Emerging risks often arise in the context of a new mindset we see among some bank directors and management. This mindset is often associated with the culture of technology companies—a "move fast and break things" philosophy that can be incompatible with prudent banking practices. Prudent banking, in contrast with a start-up culture, requires a cautious approach to new business models, a recognition of and respect for operating in a regulated industry, and an appropriate degree of expertise and oversight. Merging these philosophies—the need to innovate in an increasingly competitive banking industry, and the need to have management and board oversight that is appropriate in the highly regulated banking system—can be difficult but is critical for long-term success. Having appropriate expertise to engage in new activities within a bank can be particularly challenging with the seemingly constant advent of new technologies, like artificial intelligence, that have the potential to transform banking. While innovation in banking is important, banks may have difficulty attracting relevant expertise. But with the potential of new technologies comes grave responsibilities to ensure that they are well understood, well-managed, and used appropriately when they are introduced in a banking environment. The banking system is not an unregulated petri dish.

Regulators play a vital role in making sure the banking system is safe and sound in light of these evolving risks. At a threshold matter, regulators must consider the many tradeoffs involved in how to support banks in their quest to be agile in offering new services and responding to new and evolving risks, and in how to appropriately identify, supervise, and regulate these risks. In my view, one of the most important roles of regulators in the face of changes to the banking system is to support responsible innovation as banks provide credit to their communities and customers.[3] In doing so, they must provide clear guidance to regulated institutions to help facilitate effective risk management, and support safety and soundness. The "start-up" mindset can be a particular challenge for regulators, as the communication of traditional supervisory messages may not resonate when delivered to directors and bank management that are not accustomed to interacting with examiners, or who are unfamiliar with operating a business in a regulated industry. In these situations, regulators must communicate clearly to ensure bank leadership understands and recognizes that safety and soundness must

[3] See Michelle W. Bowman, "The Innovation Imperative: Modernizing Traditional Banking," speech at the Independent Community Bankers of America ICBA Live 2023 Conference, Honolulu, Hawaii, March 14, 2023, https://www.federalreserve.gov/newsevents/speech/bowman20230314a.htm.

always be a key priority. The approach of asking forgiveness instead of permission is not compatible with the banking system.

Neither regulators nor banks have the ability to predict the future, and yet as we look back on large structural shifts in the banking system, many of these longer-term trends were foreseeable. As we consider these ongoing evolutions in terms of both risks and opportunities, we must remember the fundamental role of banks in providing credit to consumers and businesses, including small- and medium-sized businesses.

### *Regulatory Dynamics and the Regulatory Perimeter*

Earlier this year, I shared three resolutions that will guide my approach to regulation in the coming year, and beyond:

1. prioritize safety and soundness in the execution of our regulatory responsibilities when it comes to both enacting regulation and conducting supervisory examinations,
2. renewing our commitment to tailoring, and
3. increasing transparency in supervisory expectations.[4]

I continue to believe that adherence to these principles will help buttress the safety and soundness of banks.

In some ways, these priorities focus on the "how" of regulation and supervision—how we engage in prioritization of supervision, how we make policy decisions, and how we engage with regulated institutions and the public. Of course, another equally important consideration—relevant for regulators and those who run banks—is the "why," which goals and objectives should be kept in mind in the execution of these responsibilities. An awareness of the impacts of

[4] See Michelle W. Bowman, "New Year's Resolutions for Bank Regulatory Policymakers," speech at the South Carolina Bankers Association 2024 Community Bankers Conference, Columbia, South Carolina, January 8, 2024, https://www.federalreserve.gov/newsevents/speech/bowman20240108a.htm.

regulation and supervision—the intended and unintended consequences of changes to the bank regulatory framework—must underpin the regulatory process.

Policymakers often acknowledge that the diversity of banks—with a wide range of sizes, locations, and activities—contributes to the strength of the banking system. As I have noted in the past, research supports this perspective.[5] Banking reforms that result in over-regulation, or excessive compliance burdens that are disproportionate to risk, can threaten the banking system, and by extension, the U.S. economy. The cyclical nature of risks—and the perception that fundamental transformation of the regulatory framework is the only cure—can often contribute to instability in the regulatory approach and in the financial system. Targeted changes—changes that ensure *ongoing* attention to long-recognized risks and nimbleness to deal with emerging risks—can often be more efficient and effective in addressing the concerns on a permanent basis. I do not envy bankers that have to deal with regulatory whiplash. Establishing a consistent framework to deal with regulatory risks, a framework that is broadly supported through consensus and analysis, is often a better and more permanent solution to enhance safety and soundness than more pronounced swings of the regulatory pendulum.

As the role of banks continues to evolve, we must continue to ask difficult questions about the functioning of the regulatory framework, and whether it requires adjustments: How do we define a "community bank" for purposes of tailoring regulations to risks? What are the implications of regulatory cliff effects, like those around regulatory capital thresholds under the Basel III endgame and long-term debt proposals, where there is a new, stark line at $100 billion in assets? Will regulatory proposals effectively impact the viability of certain institutions,

[5] See 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, St. Louis, Missouri, October 4, 2023, https://www.federalreserve.gov/newsevents/speech/bowman20231004a.htm.

particularly those clustered around regulatory thresholds? What would the loss of these smaller institutions mean for credit availability and pricing? In all of these policy decisions, banks must not be passive observers. They must ensure the that regulators and policymakers recognize and understand their important role and the impacts of considered changes to ensure their viability in the future.

Of course, while we often think of the banking system as being defined by a "regulatory perimeter"—a line that distinguishes institutions that are subject to direct oversight from those that are not—this line in some ways blinds us from some of the important and unintended consequences we must consider in shaping the regulatory framework. Banks are an integral part of the larger financial system, and financial risks, including financial stability risks, are not unique to banks. For example, we know that the cost of capital influences not only the pricing of financial services offered by banks, but *where* activities occur, either within the regulatory perimeter or in nonbank entities and the shadow-banking system. I worry about the migration of risks across this line and what it means for the stability of the U.S. financial system. But I am particularly concerned about intentional regulatory actions that actually *push* activity to the nonbank financial system. In my view, this structural dynamic—where activities occur and how those choices are influenced by regulation—is one that banks themselves must be concerned with, as over the long-term, it will affect every decision they make about the products and services they offer.

While regulatory choices can affect the scope of the regulatory perimeter, these choices can also help to mitigate the flow of risk between the permeable boundary separating regulated banks and other companies. Regulators often address risks in the financial system by focusing on regulated banks, promoting up-front due diligence of bank partners, monitoring the risks of these relationships, and placing accountability for issues that arise on the banks themselves. A potentially underused tool that could be used to address these risks is oversight of third-party service providers under the authority granted to banking regulators under the Bank Service Company Act. Better aligning supervisory attention with the source of risk in this way could be a more efficient mechanism to address risks on the borders of the regulatory perimeter.

**Closing**

In closing, thank you again to the Southwestern Graduate School of Banking for the invitation to discuss my thoughts about the future of banking. Bank management and directors face significant challenges in preparing for an unpredictable future, a future that will be impacted by emerging risks, new business opportunities, regulatory actions, and many other factors beyond a bank's immediate control. While the factors I have highlighted do not—and could not possibly—provide a roadmap to the future, they do provide a different way of thinking about the long-term challenges and opportunities in the banking industry, a perspective that may be helpful for bank directors, bankers—and even for regulators.