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Taking a Fresh Look at Supervision and Regulation

Remarks by

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at the

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It is a pleasure to join you today for my first public remarks as the Federal Reserve Board's Vice Chair for Supervision.[1] Today, I will describe my approach to leading the Fed's Division of Supervision and Regulation in its vital work to promote the safe and sound operation of the U.S. banking system. I have spoken extensively in the past about my principles for supervision and regulation, which will continue to guide my approach to supervision and the bank regulatory framework.[2]

At the core of these principles is pragmatism, which focuses on first identifying the problem to be solved and then developing efficient solutions.[3] Once we have identified a need for reform, or a problem to be solved, our next task is to conduct a careful analysis of the intended and unintended consequences of any proposed policy solution, and to consider alternative approaches that lead to lower cost or better outcomes.

The views I share with you today reflect my initial thoughts about how these principles should be incorporated into the important work that will be required to improve supervision and regulation in the future, addressing: (i) enhancing supervision to more effectively and efficiently meet the Fed's safety and soundness goals; (ii) reviewing and reforming the capital framework to ensure that it is appropriately designed and calibrated; (iii) reviewing regulations and information collections to ensure that this framework remains viable; and (iv) considering approaches to ensure the applications process is transparent, predictable, and fair.

Enhancing Supervision

Supervision focused on material financial risks that threaten a bank's safety and soundness is inherently more effective and efficient. We should be cautious about the temptation to overemphasize or become distracted by relatively less important procedural and documentation shortcomings. Fundamentally, as I've noted in the past, our goal should be to prioritize the identification of material financial risks and encourage prompt action to mitigate risks that threaten safety and soundness. There are a number of changes we can adopt in the near term to better enable us to accomplish this goal:

Tailoring. Risks are not uniform, and each bank is unique based on its business model, complexity, and business profile. I am a long-time proponent of tailoring banking regulations. Going forward we will extend the application of tailoring to our supervisory approach to financial institutions, not only among bank categories, but also within a particular category.

In the past, the Board has "pushed down" requirements developed for the largest firms to smaller banks, often including regional and community banks. One approach that would preserve tailoring is to create an independent community bank supervisory and regulatory framework to clearly separate these banks from larger bank supervision and regulation. This would serve to insulate these smaller banks from standards designed for larger and more complex firms. While I have no objection to a deliberate, intentional policy to apply similar standards to firms with similar characteristics as conditions warrant, the gradual erosion of distinct regulatory and supervisory standards among firms with very different characteristics—essentially the subtle reversal of tailoring over time—is not a reasonable approach for implementing supervision and regulation.

Both regulators and legislators should consider whether the bank regulatory framework includes appropriate thresholds for defining distinct categories of institutions, and whether simple fixes—for example the indexing of thresholds to inflation or growth—could better ensure a sound, tailored approach that remains durable over time. It is clear that the current $10 billion threshold defining the upper bounds of a "community bank" leaves many institutions that pursue this business model—of community and relationship-based banking—subject to heightened requirements more suitable for larger and more complex firms.

To further these objectives, later this year I will host a conference on small and community bank issues, to discuss improving the bank regulatory framework to adopt a more efficient, tailored approach for these firms. We must demonstrate wisdom and courage by carefully listening to those who are subject to regulatory oversight and considering ways to enhance our approaches to both supervision and regulation.

One issue that continues to present challenges to smaller banks is check fraud. The ongoing increase in bank losses to this type of fraud can negatively impact the perceived safety of the banking system and result in significant consumer harm. Past efforts by regulators have been frustratingly slow to advance and seem to have done little to address the underlying root causes of this increase in fraud. I will continue to work to identify specific actions that can be taken to reduce the incidence of fraud, including through expediting the remediation process from check fraud after it occurs. I expect that the Federal Reserve, in coordination with the OCC and FDIC, will soon take action on this front.

Ratings. Ratings must reflect risk, and yet we have seen gradual changes in supervisory approaches that have eroded the link between ratings and financial condition.[4] Federal Reserve supervisory statistics show that that two-thirds of the largest financial institutions in the U.S. were rated unsatisfactory in the first half of 2024.[5] At the same time, the majority of these same institutions met all supervisory expectations for capital and liquidity.

This odd mismatch between financial condition and supervisory ratings requires careful review and appropriate revisions to our current approach. Under the current large bank ratings framework, a single component rating can result in a firm being considered not "well-managed," which has driven the disparity between well-managed status and financial condition.

The Federal Reserve will soon begin to address this mismatch, by proposing changes to the Large Financial Institution ratings framework. The proposed changes will be designed to result in a more sensible approach to determining whether a firm is well-managed, no longer disproportionately weighting a single framework component for a firm that has demonstrated resilience under a range of conditions and stresses.

This initial change should help address the gap between assessed ratings and material financial risk for those firms subject to this framework. We have an obligation to ensure that our supervisory ratings are current, credible, and reflect material financial risk. This promotes effective supervision and ensures that firms are accurately rated based on their underlying financial strength, which should increase the public's confidence in our assessment of the banking system.

We must also consider the appropriateness of the broader ratings framework which applies to smaller institutions, including the CAMELS framework. Are these frameworks appropriately tailored to capture material financial risks, particularly for elements that rely on subjective examiner judgment? While judgment is a legitimate and necessary tool in supervision, it must always be grounded in the materiality of the identified issues as they relate to the financial health of each institution and the banking system as a whole. This has been a notable shift in supervision not only for large banks, but also for regional and community banks.

Improving prioritization. Examiners review a broad range of activities in the supervisory process. A random sample of examination reports demonstrates that supervisory focus has shifted away from core financial risks (credit risk, interest rate risk, and liquidity risk, for example), to process-related concerns. While process is important for effective management, there is a risk that overemphasis on process and supervisory box-checking can be a distraction from the core purpose of supervision, which is to probe financial condition and financial risk. Checklists should not distract examiners from the central purpose of examinations.

Another tool that we will be reviewing with a critical lens is the use of horizontal reviews. In theory, horizontal reviews—where examiners conduct a narrow but deep review on a particular topic across multiple banks—can help improve an examiner's perspective. Horizontal reviews, when used effectively, can help supervisors better understand the range of industry practices.

But these reviews have quickly evolved into oversimplification of complex issues and often include "grading on a curve," where firms are rank-ordered, with an expectation that implementing a simpler approach fails to meet expectations, under the assumption that the more complex approach is appropriate for all firms. However, this side-by-side comparison fails to address the only question that matters: whether a firm's approach meets appropriate legal and supervisory standards for the individual firm's characteristics. Differences in approaches are not indicative of shortcomings, particularly since these can often be explained by distinguishing the underlying activities, scope and scale of operations, and risk tolerance of the firm's board and management.

There is also a lack of transparency in the results of these exams, and a risk that horizontal reviews will create generally applicable rules without complying with the Administrative Procedure Act (APA). I will be looking closely at whether the continued use of horizontal exams going forward is appropriate, and if so, to ensure that these exams are sufficiently transparent, they reflect proper respect for the APA, and do not circumvent our responsibility to provide each regulated institution with a fair, firm-specific evaluation.

The role of guidance in supervision. Finally, I will discuss the important role of guidance in the supervisory process. Guidance can be an effective tool to promote transparency in supervisory expectations, to provide clarity to regulated institutions on the permissibility of new activities and their associated risks, and to provide firms some perspective on how they may comply with statutory and regulatory requirements. Structured with these goals in mind, guidance can further the objective of supervisory prioritization.

Where guidance does not further these objectives, it is worth revisiting. I think it is important that we review a wide range of existing guidance, including outstanding Supervision and Regulation Letters (SR Letters), topical guidance that addresses issues that may adversely affect innovation (like the extensive guidance that has some bearing on third-party risk management), and the many other guidance documents that have been issued in recent years.

Fundamentally, guidance should clarify expectations, and provide answers to industry questions, such as our earlier “office hours” guidance that provided a venue for banks and innovators to share information on new products and services like digital asset activities and artificial intelligence.

Changing expectations around the use of guidance, as a tool to promote clarity in supervisory expectations, can encourage innovation in the banking system. Uncertainty in supervisory expectations has long been an obstacle to banks seeking to innovate, including banks engaging in digital asset activities or incorporating new technologies like artificial intelligence to improve efficiency and delivery of products and services. Just as it is imperative that banks innovate to remain competitive in the future, it is critical that bank supervisors enable the adoption of new technologies in a manner consistent with safety and soundness.

Examiner training and workforce development. Examiners must engage in a challenging course of study and pass rigorous tests before qualifying to become a commissioned bank examiner. Those who have obtained this license have a strong foundation that they can rely on to conduct appropriate examinations. The commission demonstrates an elevated level of expertise, judgment, and fairness that these examiners bring to their work. As such, they should not shy away from transparency or public accountability.

Currently, the Federal Reserve does not require all staff involved in supervision and bank examination to have met or to be on a path to meet this credential. Regulated entities should be able to expect that all of our examination and supervisory teams have achieved or are working to achieve this level of professional expertise. Going forward, the Fed will prioritize this training, particularly as we face an aging workforce across the Federal banking agencies that will require our new examination staff to ensure the safety and soundness of the banking system into the future. Failure to invest in and plan for examiner training today will result in much less effective supervision in years to come.

Capital

Capital requirements are an important component of the prudential regulatory framework and are essential for the stability of interconnected banking and financial systems around the world. Yet too often, our efforts to address capital reform take a piecemeal approach to capital requirements. We tend to review individual elements of the capital framework in isolation, without considering whether proposed changes are sensible in the aggregate and contribute to a capital framework in which all components work together effectively.

While each component is important, the aggregate calibration of requirements is ultimately the most meaningful, and we must examine whether this approach in totality appropriately captures risk. Over-calibrated capital requirements effectively create market distortions, disfavoring some activities over others in a way that is divorced from prudential safety and soundness goals and economic conditions.

Leverage ratios are one example that illustrates this concern. The Federal Reserve has long acknowledged that leverage ratios are intended to act as a "backstop" to risk-based capital requirements. When leverage ratios become the binding capital constraint at an excessive level, they can create market distortions. This is especially true in the case of the enhanced supplementary leverage ratio (eSLR) which is applicable to the largest banks.

As a result of this leverage requirement, banks are less inclined to engage in low-risk activities like Treasury market intermediation and revise their business activities in a way that is neither justified nor responsive to their customer needs. These distortions can also create broader financial system impacts like increased stress on Treasury market functioning. To be clear, the increasing bindingness of the eSLR on the largest firms did not result from careful policy debate and discussion. Instead, it is an unintended consequence of market and other bank regulatory requirements implemented after it was originally put in place.

The original calibration of the eSLR was based on forecasts of the level of reserves and other so-called "safe assets" in the system that are now far out of line with current levels. I expect that in the near future, the agencies will publish a proposal to help address this concern and ensure that the eSLR resumes functioning as a backstop capital requirement.

While this fix to the eSLR is necessary, it may not be sufficient to address issues in the capital framework. In July, the Federal Reserve will host a conference that will broaden our perspective in the consideration of capital requirements for large banks. We will bring together bankers, academics, and other capital experts to examine whether capital requirements as currently structured and calibrated are operating as intended—in a complementary fashion.

I welcome the opportunity to consider a broader range of perspectives as we look to the future of capital framework reforms. In addition to considering potential changes to leverage ratio requirements and stress testing, the capital conference will also include a discussion of potential reforms to the GSIB surcharge and the Basel III capital requirements.

The Board has already proposed a significant change to reduce the volatility in capital requirements resulting from our current stress testing process. The proposal includes providing a longer implementation timeline to phase in the annual stress capital buffer requirement. And later this year, the Board will consider more extensive changes aimed at promoting transparency, fairness, and predictability in the stress testing program.

While stress testing is an important supervisory tool, its implementation, outcomes, and processes have raised significant questions and concerns about its effectiveness in identifying systemic weakness. The lack of transparency around the models used in stress testing prevents meaningful discussions about how the stress tests can be improved.

Capital has an impact on the business activities of all banks. Although the capital framework for the smallest institutions tends to be simpler and more straightforward, calibration and design elements play an important role in the functioning of smaller banks just as they do for larger banks. Therefore, it is important that we also take the opportunity to address issues for smaller banks, that provide critical support to their local communities and the economy. On this front, we will review and consider the community bank framework, including capital requirements like the calibration of the community bank leverage ratio, and whether reforms to the capital framework for mutual banks can be improved to promote capital formation.

I look forward to the results of public engagement on these issues, including through the upcoming conferences. As we consider bank capital requirements, the focus should be on achieving a capital framework that provides a strong foundation for the banking system, appropriately requires banks to hold capital corresponding to risk, and works together with bank supervision to support a safe and sound banking system.

Review of Regulations and Information Collections

Since the passage of the Dodd-Frank Act nearly 15 years ago, the body of regulations that all banks are subject to has increased dramatically. Many of the reforms made after the 2008 financial crisis were important and essential to ensuring a stronger and more resilient banking system. Yet, a number of the changes were backward looking—responding only to that mortgage crisis—not fully considering the potential future unintended consequences or future states of the world.

With well over a decade of change in the banking system now behind us post-implementation, it is time to evaluate whether all of these changes continue to be relevant. Some of the regulations put in place immediately after that financial crisis resulted in pushing foundational banking activities out of the regulated banking system into the less regulated corners of the financial system. We need to ask whether this was and continues to be appropriate. These tradeoffs are complicated, and we must consider not only the changes that were made but also the evolution of and differences in the banking system today.

Driving all risk out of the banking system is at odds with the fundamental nature of the business of banking. Banks must be able to earn a profit and grow while also managing their risks. Adding requirements that impose more costs must be balanced with whether the new requirements make the correct tradeoffs between safety and soundness and enabling banks to serve their customers and run their businesses. The task of policymakers and regulators is *not* to eliminate risk from the banking system, but rather to ensure that risk is appropriately and effectively managed.

In a well-functioning, regulated banking system, banks serve an indispensable role in credit provision and economic stability. The goal is to create and maintain a system that supports safe and sound banking practices, and results in the implementation of proper risk management. Our goal should not be to prevent banks from failing or even eliminate the risk that they will. Our goal should be to make banks safe to fail, meaning that they can be allowed to fail without threatening to destabilize the rest of the banking system.

Maintenance of the regulatory framework is necessary to ensure that our regulations continue to strike the right balance between encouraging growth and innovation, and safety and soundness. One easily identifiable way to achieve this is using the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) review process, which the agencies initiated in February of last year.

The EGRPRA review process requires the federal banking agencies to identify any outdated, unnecessary, or overly burdensome regulations, eliminate unnecessary regulations, and take other steps to address the regulatory burdens associated with outdated or overly burdensome regulations. Prior iterations of the EGRPRA process have been underwhelming in their ability to result in meaningful change, but it is my expectation that this review, and eventually the accompanying report to Congress, will provide a meaningful process for stakeholders and the public to engage with the banking agencies in identifying regulations that are no longer necessary or are overly burdensome. It is also my expectation that regulators will be responsive to concerns raised by the public.

Another area that is ripe for review are several of the Board's rules that address core banking issues—from loans to insiders, to transactions with affiliates, to state member bank activities, and domestic and foreign activities of bank holding companies. Many of the Board's regulations have not been comprehensively reviewed or updated in more than 20 years. Given the dynamic nature of the banking system and how the economy and banking and financial services industries have evolved over that period, we should update and simplify many of the Board's regulations, including thresholds for applicability and benchmarks.

Banking Applications

The process to file an application and receive regulatory approval, whether it involves banks seeking a *de novo* charter, institutions seeking to merge, or any other application for bank regulatory approval should reflect both (1) transparency as to the information required in the application itself, and the standards of approval being applied, and (2) clear timelines for action.

Recent experience with banking applications suggests that revisions would be helpful in this space. Streamlining the applications for *de novo* formation, and establishing clearer standards for approval, may encourage more *de novo* activity.

Similar problems have affected bank mergers and acquisitions, where there have been lengthy processing delays. We need to rethink whether many of the additional requests for information can be addressed through better application forms or relying on information that is available from bank examinations. We should also consider factors that force applications to be moved from Reserve Bank-delegated processing to requiring consideration by the Board. One example is the perverse effect of "competitive" screens that disproportionately affect transactions in rural and underserved banking markets. Another is the treatment of adverse public comments that may lack factual support or rely on matters already considered in the review process, including existing supervisory records.

Closing Thoughts

I am honored to have the opportunity to serve as the Vice Chair for Supervision. The work of supervision and regulation is critical to maintaining a safe and sound banking system and protecting U.S. financial stability. Conditions constantly evolve in the banking system, and so too must the regulatory and supervisory framework. We must be proactive and responsive in the face of emerging risks and ensure that the framework operates in an efficient and effective manner.

The steps I have identified today are intended to further these goals by creating an initial roadmap to refocus supervisory and regulatory efforts on the core financial risks most critical to maintaining a healthy and resilient banking system. I look forward to working with my Board colleagues and my counterparts at the other banking agencies as we pursue sensible and pragmatic reforms.

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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, e.g., Michelle W. Bowman, "Bank Regulation in 2025 and Beyond" (speech at the Kansas Bankers Association Government Relations Conference, Topeka, KS, February 5, 2025), https://www.federalreserve.gov/newsevents/speech/bowman20250205a.htm; Michelle W. Bowman, "Innovation in the Financial System" (speech at the Salzburg Global Seminar on Financial Technology Innovation, Social Impact, and Regulation: Do We Need New Paradigms?, Salzburg, Austria, June 17, 2024) https://www.federalreserve.gov/newsevents/speech/bowman20240617a.htm; Michelle W. Bowman, "Tailoring, Fidelity to the Rule of Law, and Unintended Consequences" (speech at the Harvard Law School Faculty Club, Cambridge, MA, March 5, 2024), https://www.federalreserve.gov/newsevents/speech/files/bowman20240305a.pdf; Michelle W. Bowman, "New Year's Resolutions for Bank Regulatory Policymakers" (speech at the South Carolina Bankers Association 2024 Community Bankers Conference, Columbia, SC, January 8, 2024) https://www.federalreserve.gov/newsevents/speech/bowman20240108a.htm;

[3] Michelle W. Bowman, "Approaching Policymaking Pragmatically" (remarks to the Forum Club of the Palm Beaches, West Palm Beach, FL, November 20, 2024), https://www.federalreserve.gov/newsevents/speech/files/bowman20241120a.pdf.

[4] See Board of Governors of the Federal Reserve System, *Supervision and Regulation Report* at 16-17 (Washington: Board of Governors, November 2024), https://www.federalreserve.gov/publications/files/202411-supervision-and-regulation-report.pdf (describing data for the first half of 2024, the most recent period for which data is available).

[5] Board of Governors of the Federal Reserve System, *Supervision and Regulation Report*.