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Remarks on the Economy and Prioritization of Bank Supervision and Regulation

by

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at

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It is a pleasure to join you this morning for the New York Bankers Association's Financial Services Forum.[1] I look forward to hearing your perspectives on the economy, the financial system, and, more recently, the Federal Reserve's regulatory reforms which help to shape my perspective on these issues. This month marks five years since I joined the Board of Governors of the Federal Reserve System. Over the years, I have drawn heavily upon my experience as a former state bank commissioner and a banker in carrying out my responsibilities, especially as they relate to bank supervision, payments, and consumer and community affairs. This perspective informs my views about evolving bank regulations and the real-world impact that changes can have on financial institutions, their local communities, and the broader U.S. economy.

As you know, the federal regulatory agenda has been very active lately, with a significant volume of rules, guidance, and supervisory reforms either recently published or in the pipeline. Today, I will offer my thoughts on some of these developments, to lay a foundation for a discussion about the vital importance of the prioritization of supervisory and regulatory approaches for the banking system. As the agencies move forward with an active and potentially disruptive reform agenda, we should pause, reflect upon these changes, and ask several questions: Are these reforms efficient? In totality, do they work together to enhance the regulatory framework, resulting in a rational and efficient framework? Are the reforms within the scope of our statutory authority? Have we met the appropriate standards of due process and public engagement? And, given the

[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.

current economic and banking landscape, are we focusing on the appropriate regulatory and supervisory priorities?

Before I dig a bit deeper into these questions, including the critical importance of prioritizing supervisory and regulatory actions, I'd like to offer a few thoughts on the economy and monetary policy.

After sharply tightening monetary policy over the past year and a half to reduce inflation, at our November meeting, the Federal Open Market Committee (FOMC) voted to maintain the target range for the federal funds rate at 5¼ to 5½ percent and continued the run off of the Fed's securities holdings.

We have seen considerable progress on lowering inflation, but inflation remains high and recent readings have been uneven. The latest personal consumption expenditure (PCE) inflation index data showed 12-month changes in total and core inflation of 3.4 percent and 3.7 percent, roughly similar to the previous month's reading. However, some components of core services inflation have picked up, and I see a continued risk that core services inflation remains stubbornly persistent. In my view, there is also a risk that higher energy prices could reverse some of the progress made to bring overall inflation down.

The economy has remained strong as the FOMC raised the federal funds rate, and recent data indicate that economic activity has accelerated with real gross domestic product (GDP) growing at a 4.9 percent annual rate in the third quarter. Consumer spending has also accelerated, and the housing sector appears to be continuing to rebound.

The latest employment report showed a labor market with healthy job gains. Over the past year, labor force participation has improved with the average pace of job gains slowing somewhat, a sign that labor market supply and demand may be coming into better balance.

Throughout the past few years, we have seen continued significant data revisions, with the most recent of these revisions reflecting significant changes to employment data. Job gains in prior months were revised lower, but average hourly earnings for the past 12-months were revised higher. The frequency and extent of data revisions make the task of predicting how the economy will evolve even more challenging, and I will continue to monitor these data carefully.

While I continue to expect that we will need to increase the federal funds rate further to bring inflation down to our 2 percent target in a timely way, I supported the FOMC's decision last week to hold the target range for the federal funds rate at the current level as we continue to assess incoming information and its implications for the outlook. Currently, the federal funds rate appears to be restrictive, and financial conditions have tightened since September.

Some of this tightening has occurred through longer-term bond yields, which can be volatile over time as conditions change. For example, since the November FOMC meeting, the 10-year Treasury yield has declined by around 35 basis points, or a bit more than half of the increase in the 10-year yield since our September meeting. A variety of models attribute a significant portion of the increase in longer-term yields to higher term premiums. There are a number of potential factors that may be influencing term premiums, including an improved economic outlook, higher Treasury debt issuance,

concerns about future inflation risk, and higher uncertainty about the future path of the economy and monetary policy. Any or all of these factors may contribute to the movement of longer-dated yields. I will continue to monitor these and the broader financial conditions to observe changing conditions and any potential effects on economic activity and inflation and to better understand the implications for appropriate monetary policy.

I am also closely watching liquidity conditions and Treasury market functioning, which have held up well so far even amidst large movements in yields. The U.S. Treasury market plays a central role in the transmission of monetary policy, in financing the federal government, and in providing safe and liquid assets to support the flow of capital and credit to households and businesses. Treasury market liquidity strains could be amplified and spill over to related financial markets if longer-dated Treasury securities experience an abrupt selloff and investors reposition their portfolios in response to a rapid increase in long-term Treasury yields. Financial market volatility spurred by additional geopolitical shocks could further strain financial market functioning. These risks could be exacerbated if bank holding company-affiliated market makers experience balance sheet constraints during periods of volatility. It is also important that Treasury markets remain resilient and stable.

More broadly, I believe we should keep in mind that we don't yet know the effects of tightened financial conditions on economic activity and inflation. There is an unusually high level of uncertainty regarding the economy and my own economic outlook, especially considering recent surprises in the data, data revisions, and ongoing

geopolitical risks. But I will be closely watching the incoming data as I assess the implications for the economic outlook and appropriate monetary policy.

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. I remain willing to support raising the federal funds rate at a future meeting should the incoming data indicate that progress on inflation has stalled or is insufficient to bring inflation down 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 will turn now to address recent developments in the ongoing reform of the bank regulatory framework. While this is by no means a comprehensive list of all recent reforms—or more that may come in the months ahead—I will share some thoughts on capital requirement reforms; the Community Reinvestment Act (CRA); the cap on debit interchange fees; and climate guidance. I will also share my perspectives on the vital importance of prioritization of supervisory and regulatory actions by regulators. It is essential that our actions are driven by data and are specifically designed to address core banking risks or existing shortcomings in our bank regulatory framework.

Capital Requirements Reform

In July of this year, the federal banking agencies proposed significant reforms to capital requirements for banks with more than $100 billion in assets. Although many banks would not be directly affected based on their asset size, the proposal could have a significant impact on the U.S. banking market and economy.

The proposal would increase total risk-weighted assets across bank holding companies subject to the rule by an estimated 20 percent. These impacts would vary based on firm-specific attributes—but not by asset size. I have spoken in the past about my concerns with the quantitative and analytical foundations of this proposal. It is not designed to address identified regulatory deficiencies and shortcomings and gives insufficient attention to the potential unintended consequences and harm that could result if finalized and implemented in its current form.

In drafting the Basel III capital proposal, it seems clear that the agencies made broad assumptions that the current capital framework is insufficient to support bank and financial market activity. So, as a part of my remarks today, I will address the current state of capital in the banking system, concerns with the proposed changes to the capital framework, and the path forward for fair and efficient capital reform.

Current State of the Banking System

To begin, the U.S. banking system remains strong and resilient. The system is much better capitalized than after the 2008 financial crisis, with substantially more liquidity. U.S. banks are also subject to a range of new supervisory tools that did not exist prior to 2008. The current framework represents a risk-based, tailored approach, which strives to align regulation with institution and activity risk, fulfilling the congressional mandate to tailor the prudential regulatory framework.[2] The current level of capital in the U.S. banking system is a strength, not a weakness, which is complemented by liquidity regulations and other prudential requirements that have

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

contributed to the resilience of U.S. banks. These banks also continue to play an important role in the U.S. economy by extending credit, providing banking and payment services, and participating in U.S. securities and derivatives markets. Context matters, and when we discuss changes to the bank regulatory framework—including through changes to capital requirements—we need to understand the direct and indirect consequences that may result.

Potential Consequences of Capital Reform

One of the key questions I ask when considering regulatory proposals is whether the benefit of the change outweighs the costs of implementation, both for the financial institutions subject to the proposal and for the broader economy.

On a simplistic level, higher capital levels make the banking system safer. But this must be the beginning of the analysis, not the definitive end. Increased safety comes at a cost, and the business of banking is built upon risk. The complete elimination of risk would transform a bank into a public utility. Assuming this is not the desired end state of the banking system, we must evaluate a proposal's merit by thoroughly understanding the balance between these benefits and the resulting costs.

As I noted earlier, the U.S. banking system continues to be much better capitalized than before the 2008 financial crisis. That capital cushion has broadly enhanced the resiliency of the banking system through business, economic, and interest rate cycles, enabling the banking system to continue supporting the U.S. economy, even throughout the pandemic and the related economic stress.

While the full extent of "costs" under the proposal are not entirely clear, in the aggregate, those costs—including the direct costs experienced by banks, and the indirect

costs experienced by bank customers and the U.S. economy—would be substantial. Capital increases of this magnitude are likely to have a detrimental impact on U.S. market liquidity and lending, and firms without sufficient scale are likely to exit certain markets. Increased capital requirements for certain types of loans may also lead to reduced credit availability or increased cost of credit, which could disproportionately harm underserved markets, businesses, and communities. Ultimately, bank customers will bear the cost of these increases.

The Path Forward for Capital Reform

What does the path forward entail? The agencies have received substantial initial public feedback, and in response, have extended the comment period into mid-January 2024. The agencies have also engaged in a parallel effort to gather more information about the potential impact of the proposal's approach and calibrations. These actions reflect an important recognition of the proposal's length and complexity and are certainly a positive step. While it would be impossible to highlight all the issues in the proposal that raise concerns in my remarks today, I will note several areas that will be necessary to address:

- **Redundancy in the Capital Framework**. The proposal does not include an analysis of the appropriate *aggregate* level of capital requirements. This consideration is important since many of the existing enhanced capital standards that apply for U.S. banks were contemplated and finalized while the prudential regulation framework, including capital and liquidity rules, were still under development. For example, there are known overlaps and redundancies among the new market risk and operational risk requirements, and the stress capital buffer.
- **Calibration of the Market Risk Capital Rule**. The revisions to the market risk rule alone will increase risk-weighted assets from $430 billion to $760 billion for Category I and II firms, and from $130 billion to $220

billion for Category III and IV firms.[3] These increases are significant, with broad-based impacts, affecting business and municipal financing, risk management, hedging of foreign exchange and interest rate risk, or managing the risks of fluctuating commodity prices through hedging activities.

- **Inefficiency of Two Standardized Capital Stacks**. Firms subject to the new risk-based capital rule would remain subject to the standardized approach applicable to all firms, resulting in a "dual-stack" capital calculation, with the firm required to use the lower capital ratio. This approach will add complexity to the capital calculation for all firms, but it will be especially cumbersome for Category III and IV firms, applying a one-size-fits-all approach for these smaller firms despite the variation in their risk, size, business models, and complexity, likely resulting in costs that outweigh the benefits of this provision.[4]
- **Punitive Treatment of Fee Income**. The proposal adopts a punitive treatment for noninterest and fee-based income through the proposed operational risk requirements, coupled with an internal loss multiplier. Imposing this type of capital charge for operational risk can deter banks from diversifying revenue streams, even though this can enhance an institution's stability and resilience.
- **Missed Opportunity to Review Leverage Ratio Requirements**. The proposal does not address or propose changes to leverage requirements, including the 5 percent leverage ratio that applies to U.S. global systemically important banks, commonly referred to as the enhanced supplementary leverage ratio (or eSLR). Treasury market intermediation can be disrupted by constraints imposed by the eSLR, as occurred during the early days of market stress during the pandemic. It seems prudent to address this known leverage rule constraint before future stresses emerge that would likely disrupt market functioning.

Policymakers may disagree about the best choices to further supervisory goals, but we have an obligation to understand and assess the true cost of reform, going beyond the direct costs to banks and their customers to include the potential harm to U.S. bank competitiveness in the global economy. As I have noted previously, unless we consider

[3] See Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, 88 Fed. Reg. 64,028, at 64,168 (proposed September 18, 2023), https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf.

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

reforms with a thorough understanding of their combined and aggregate impact on the institutions subject to the revised regulatory framework, we create a significant risk of arriving at a capital end state that is inefficient, contradictory, and potentially harmful to banks, their customers, and the broader economy.

I also want to briefly address the role of international coordination in establishing capital standards both in the United States and around the world. International bodies and agreements can help foster the creation of similar regulatory frameworks across jurisdictions. Significant banking activities occur in the international and cross-border context, and we know that financial stability risks can spread throughout global financial markets. By engaging in international coordination, U.S. regulators can promote minimum standards across jurisdictions, and these minimum standards can improve competitive equity in banking markets and make the financial system safer.

While the capital proposal reflects elements of the agreed upon Basel standards, it is not a mere implementation of the Basel standards. In this proposal, the calibration—with a large increase in capital requirements for U.S. firms—far exceeds the Basel standards mandate. Instead, the scale of the increase is driven by deliberate policy choices to significantly increase capital requirements for U.S. banks over $100 billion, even for those that are not internationally active. As we have seen since the proposal was published, there has been growing support for improving the proposal's quantitative, analytical foundations, including the need for and impact of capital increases of this scale.

Community Reinvestment Act

Shifting away from capital rules, late last month, the federal bank regulators adopted a new final rule to implement the Community Reinvestment Act. The purpose of the CRA is to improve access to credit in all communities where banks are located, especially low- and moderate-income (LMI) communities. The CRA was enacted in 1977 shortly after the civil rights movement and against the backdrop of other significant federal laws designed to address financial inclusion and equal access to credit. I am a strong supporter of these goals and the requirements that banks support their communities to the greatest extent possible. Unfortunately, as you know, my support for the important goals of CRA did not translate into support for the final rule.

While many positive changes are included in the rule, in my view those changes ultimately did not outweigh its shortcomings, including that the agencies arguably exceeded the authority granted by the CRA statute. The rule is unnecessarily complex, overly prescriptive, and directs outcomes that result in disproportionately greater costs than benefits, adding significantly greater regulatory burden for all banks, but especially for community banks. Even the foundational question—are banks doing enough to support their communities?—is left unanswered in the final rule, perhaps because there is no evidence to support the agencies' assumption that broadly speaking, banks are falling short.

Scope and Impact on Community Banks

First and foremost, the final rule applies the same regulatory expectations for small banks as it does for the largest banks. For example, a wide range of community banks—those with more than $2 billion in assets—are treated as "large banks" under the

final rule, forcing these banks to comply with the same CRA evaluation standards as a bank with $2 trillion in assets. The lack of recognition that these banks are fundamentally different, with different balance sheets and business models, misses an important opportunity to appropriately tailor CRA expectations to a bank's size, risk, service area, and business model. This approach is a radical departure within the regulatory framework where no other provision considers a bank with $2 billion in assets as "large."

As a result of this decision, many community banks will be subject to new and materially enhanced requirements, including a new retail lending test, significantly expanded assessment areas, and increased data and reporting obligations. As I made clear throughout the development of the original proposal and final rule, instead of requiring these changes, community banks should have had the option, at their discretion, to opt into the new retail lending test and assessment areas, or to continue with the existing framework. The significant increases in burden and cost associated with these changes are simply disproportional when applied to community banks, in a way that may constrain the resources community banks can devote to supporting their communities.

Lack of Congressional Authorization

The final rule also arguably exceeds the authority granted by Congress. While the final rule aspires to modernize the CRA to account for changes in the way banks operate—for example, aligning the rule with current practices of extending credit in communities, including through mobile and online banking—there are limits to what the banking agencies can do. Congress alone has the power to modernize the CRA statute, including reflecting the variety of financial institutions that provide credit and financial

services in their communities. In my view, some of the changes made by the agencies, including those that evaluate banks outside of their deposit-taking footprint, are likely beyond the scope of our authority under the statute.

Clarity and Transparency

If these new standards were in place today, based on data from 2018 through 2020, there would be a nearly tenfold increase in banks with a "Needs to Improve" CRA rating. In some ways, this highlights a fallacy underlying these rule changes: that the low number of banks with a "Needs to Improve" rating *itself* demonstrates that the standards of the CRA regulations have been too lax historically, ignoring the more plausible explanation that banks work hard to support their communities. It is not appropriate for the banking agencies to materially increase the requirements on banks, resulting in a downgrade of currently satisfactory performance to "Needs to Improve," without a thorough, data-supported analysis that justifies a recalibration evidenced by actual shortcomings in bank activities.

Unintended Consequences and Other Problematic Provisions

Perhaps most concerning about the final rule is that it may incentivize banks to reduce their support for certain communities, forcing them to pare back lending in areas where there is a need for credit accessibility. The addition of retail lending assessment areas and outside retail lending areas, coupled with a new requirement for large banks to include an entire county instead of a partial county as an assessment area, may ultimately incentivize firms to pull back lending.

There are many other areas of the rule that raise concern—including the odd new publication of already available HMDA data, expanded reliance on summary of deposit

data, and an implementation period of two years, which is far too brief in light of the rule's extraordinary complexity. While I have confidence that banks will make the best of this new rule, and continue to support their communities, I regret that the new final rule may complicate, and in some instances frustrate, the important goals of the CRA.

Interchange Fee Cap Proposal

Also, late last month, the Federal Reserve proposed amending the regulatory cap on debit card interchange fees. For many years, bankers have expressed significant concern about external factors, like fraud, increasing the costs of supporting bank debit card programs—concerns that could be exacerbated by a lower regulatory cap on interchange fees. While the Board's proposed rule suggests that it could result in benefits to consumers, I am concerned that the costs of this fee cap revision for consumers—through the form of increased costs for banking products and services—will be real, while the benefits to consumers—such as lower prices at merchants—may not be realized.[5]

At its heart, the proposal is unfair to many issuers and in some ways regressive in its impacts. The proposed rule acknowledges the varied size, business models, and product offerings of banks subject to the interchange fee cap and yet aims to achieve "rough justice" by establishing a single cap that applies to all covered issuers. This approach will disadvantage lower-volume issuers.

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[5] The Board memo discussing the proposed revisions to the interchange fee cap suggests that "[m]erchants, … may pass on some portion of their savings from lower interchange fees to consumers." See Proposed Revisions to Regulation II's Interchange Fee Cap," memorandum, Board of Governors of the Federal Reserve System, Reserve Bank Operations and Payment Systems and Legal Divisions, October 18, 2023, p. 9, https://www.federalreserve.gov/aboutthefed/boardmeetings/reg-ii-memo-20231025.pdf.

Retail banking is an essential, core function for many smaller issuers, so this pricing dynamic may not ultimately lead them to abandon their debit card programs. Under the proposed rule, a staggering one-third of bank issuers would not be able to recover even the partial costs that factor into the interchange fee cap. For banks that operate debit card programs at a loss, presumably those costs will need to be recovered elsewhere, such as through higher borrowing costs for bank customers or through other fees for services provided, which are also targeted by the banking agencies for elimination. Higher borrowing costs or fees could be particularly harmful for low-income customers who may not qualify for credit card products or other alternatives, as banks may be forced to discontinue their lowest-margin products, including options designed to increase financial inclusion and access for LMI individuals and families. I sincerely hope that this is not the case, but it is a real and important risk.

I also want to note one other element related to the proposal. The proposal applies only to a subset of issuers—those with more than $10 billion in assets—but I expect the fee cap will continue to affect a broader range of issuers, including community banks and small credit unions. Issuers of all sizes use the same payment rails, and smaller issuers will inevitably face some pricing pressure, at least indirectly, from the interchange fee cap.

Ultimately, the net result of this proposal may be to simply shift costs from merchants to bank customers, and to make those costs far less transparent (for example, if those costs are recovered through higher loan interest rates). Of course, this proposal has been published for public comment, and my colleagues and I welcome public feedback

on the proposal, particularly on the impacts it may have on financial institutions, including those not directly subject to the rule.

Climate Guidance

On October 24, the Federal Reserve—in conjunction with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency—published guidance directing banks' approach to climate-related financial risks. The final guidance will create confusion about supervisory expectations and will result in increased compliance cost and burden, without a commensurate improvement to the safety and soundness of financial institutions or to the financial stability of the United States. This is another regulatory action that raises questions about need and legal basis, but also about whether the focus of reforms is appropriate in the current economic and supervisory environment. This guidance represents a departure from sound banking policy and potentially a distraction from more important risk-management objectives.

While the guidance adopts a specialized regime for climate risks, it does not explain why this unique treatment for climate risks is warranted. Without taking stock of risk-management practices today and evaluating whether it is appropriate as it comes to climate-related financial risks—essentially without identifying a problem statement—the guidance goes directly to solutions that are at once unclear and expensive, without clearly promoting safety and soundness or U.S. financial stability.

Under the guidance, banks must monitor and measure climate-related risks over indefinite time horizons and "develop strategies, deploy resources, and build capacity to identify, measure, monitor, and control for climate-related financial risks." The guidance includes few specifics about this data collection expectation—which surely will expand

over time—nor does it clarify how banks are intended to integrate this new information into risk-management programs and policies, and even into lending decisions. Indeed, the guidance adopts an intentionally vague standard, with an expectation that data collection and the planning horizon for "scenario analysis" to probe on such risks may extend "beyond the financial institution's typical strategic planning horizon." And yet, the benefit of requiring banks to plan for events that occur far into the future seems limited, as long-dated predictions about the future are likely to be highly speculative and heavily influenced by the underlying assumptions, and therefore of limited or no utility to the bank in managing risk. This approach is a significant departure from existing supervisory standards and includes no explanation for the deviation from normal supervisory time horizons.

In addition to being unclear, the guidance will surely be expensive to implement. The costs to implement new data collections will be substantial not only to institutions attempting to comply with uncertain elements of the guidance, but also to bank customers that will be asked to provide more information when seeking credit or other banking products. One likely potential consequence could be to discourage banks from lending and providing financial services to certain industries, forcing them to seek credit outside of the banking system from nonbank lenders. This will undoubtedly result in decreasing or eliminating access to financial services and increasing the cost of credit to these industries.

I have every confidence that banks will work diligently to try to understand the expectations created under the agencies' climate guidance and will craft an approach that works—despite the uncertainty the guidance itself creates. However, looking to the

future, I am concerned that the scope of this guidance—which is limited to banks with over $100 billion in assets—will trickle down to far smaller institutions by treating approaches adopted by large banks as "best practices" for banks of all sizes, resulting in a much higher regulatory burden for these firms.

I am also concerned that the actions taken by banks to manage climate risk could have unintended consequences for LMI communities, including increasing the cost of credit or reducing credit availability in those communities. Oddly, while the guidance acknowledges this concern, it does not emphasize the obligations banks have under the CRA to help meet the credit needs of the communities in which they do business, especially in LMI communities.

While climate change is an important public policy issue in the United States and globally, the Federal Reserve has limited, narrowly focused mandates and responsibilities that are established by statute. These mandates and responsibilities do not extend to climate policymaking.[6] Although the climate guidance nominally focuses on climate-related "financial risks," I am concerned that the guidance could be used by the Federal Reserve and other federal banking agencies to pursue climate policies leveraging the opacity of the supervisory process, even though such actions would clearly exceed the statutory authorities given to the Board by Congress.

Prioritization of Regulation and Supervision

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[6] While the climate guidance was released shortly after the U.S. Department of the Treasury's pronouncements about net-zero financing and investment, the climate guidance is silent about "net-zero" commitments. See U.S. Department of the Treasury, Principles for Net-Zero Financing & Investment (Washington: U.S. Treasury Department, September 2023), https://home.treasury.gov/system/files/136/NetZeroPrinciples.pdf.

I'd also like to spend a few minutes on a topic that has been an undercurrent throughout my remarks so far: prioritization of supervisory and regulatory actions. In my view, it is essential that regulators appropriately calibrate and prioritize their supervisory and regulatory actions. Failing to do so could distract banks, bank management, supervisors, and regulators from focusing on key risks.

As I noted earlier, the banking system remains strong and resilient, and banks are much better capitalized, with substantially more liquidity compared to 2008. The banking agencies also have substantially more tools available than they did two decades ago. Yet, in light of recent actions taken by regulators, some could be led to question whether this was truly the case. We have seen several complex and lengthy proposals, rules, and guidance that do not relate to core banking risks and many other regulatory actions that do not appear to be designed to address shortcomings in our existing bank regulatory framework. In addition, our supervisory posture may have overcorrected relative to the risks that some institutions may face following the banking stress earlier this year.

On supervision, the primary focus of supervision should be to address a bank's critical shortcomings in a timely way. To effectively support a well-functioning and stable banking system, bank supervision must not simply pinpoint compliance issues, failed processes, or rule violations. Instead, bank supervision must focus on a bank's risk exposures, while prioritizing core safety and soundness issues in the context of the bank's financial condition. If the supervisory process fails to identify and escalate critical risks or to hold management accountable for known deficiencies, such as excess interest rate risk taking, that raises the potential for supervisory shortcomings, including impacting the

ability of supervisors to anticipate how changes in the economy or banking sector could affect a bank's condition.

At the same time, I have also heard reports, including from a number of state banking regulators, that some recent supervisory actions are excessive in light of the risks posed by certain smaller institutions. These reports of increased scrutiny, including on community and smaller regional banks—banks that were not responsible for the banking stresses earlier this year—are concerning, as they could undermine the nature of joint supervision between state and federal supervisors under the dual banking system. Overzealous supervision is just as problematic as inattentive supervision. If banks are overwhelmed with remediating issues that do not relate to core supervisory risks, bank management may be distracted from key risks. It is essential that supervisors focus on key and critical issues.

We have seen a significant number of regulatory and guidance changes this year compressed into a very short time frame. These changes do not appear to be prioritized based on known shortcomings or deficiencies in our existing regulatory framework. Several of the rules I just discussed demonstrate that we have missed the mark on prioritizing our regulatory agenda. Instead, some of our actions could distract bank management from focusing on important and key risks.

The Board's new climate guidance is emblematic of this, but it is not the only example. While climate change is an important issue, climate change is not a core risk to the safety and soundness of financial institutions. The lessons learned from supervisory failures during the bank stress in the spring clearly illustrate that bank examiners and bank management should focus on core issues, like credit risk, interest rate risk, and

liquidity risk. I am concerned that focusing our regulatory reform and guidance efforts on issues like climate change that do not represent core banking risks will only serve to further distract bank management and supervisors.

Finally, regulatory reform can also pose significant financial stability risks. The cumulative effects of recent proposed and final rules remain to be seen, but these significant regulatory changes could present ongoing risks to the health of certain institutions and the U.S. banking system. Many of the rules will be costly and burdensome to implement and are not based on any identified deficiencies in our regulatory toolkit. For example, the Basel III proposal increases capital for the largest banks, but there has yet to be a data-driven analysis demonstrating that capital levels in the banking system are currently deficient or improperly calibrated. In addition, while the CRA serves a tremendously important purpose, there was no urgency to finalize this rule at a time when we have yet to fully address potential shortcomings in our regulatory and supervisory tools stemming from the banking stress earlier this year.

Conclusion

The recent volume and materiality of new reforms implemented and under consideration by the federal banking agencies is significant. The rules and guidance total over 5,000 pages since July. While the unintended consequences of these reforms may not be clear at the outset, our ability to predict these consequences is even more limited when the reforms overlap or conflict. The sheer volume of change presents significant challenges for banks, who will be required to prioritize the implementation of new and revised requirements, with the risk of being distracted from more material concerns or supervisory issues.

My voting record on these proposals is a reflection of my concern about the path of regulatory reform, particularly in the wake of the bank failures and banking system stress earlier this year, which highlighted that some reforms may be warranted, where they address specific problems or clearly identified shortcomings. Regulators, like banks, should never shy away from improving and evolving as the underlying conditions evolve. But taking our focus away from potentially more pressing matters, like interest rate and liquidity risk management, could result in supervisors and banks that are less prepared and able to deal with emerging stresses.

In my view, our regulatory agenda should focus on evolving conditions and data-driven, identified risks. When we are distracted by risks and matters that are tangential to our mandates and areas of statutory responsibility, we may inadvertently miss other, more pressing areas that require our attention.