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Building a Community Banking Framework for the Future

Remarks by

Michelle W. Bowman

Member

Board of Governors of the Federal Reserve System

at

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It is an honor to return to St. Louis for the 12th year of the Community Banking Research Conference.[1] This conference is a model of effective partnership between the Federal Reserve and the Conference of State Bank Supervisors, and more recently, the Federal Deposit Insurance Corporation (FDIC). It is an opportunity for us all to dig deeper into the community banking model and the important role of community banks now and into the future. Together, regulators work to ensure that the approach to supervision and regulation is fit for purpose, and that each element of both supervision and regulation acts in a complementary manner. Policy disagreements are a healthy part of the process, but we must also strive to build consensus where we can. At a minimum, we must understand and respect our counterparts' and colleagues' viewpoints. Ultimately, we all share the same goal of promoting a safe and sound banking system.

The strength of the U.S. banking system relies upon the diversity of its institutions, and facilitating an environment that allows each category of bank to thrive is essential to fostering a healthy financial system. For community banks, this includes building a framework that better supports the unique characteristics of these institutions. Today, my remarks will consider three foundational questions as we contemplate revising the community banking framework: (1) Given the continued evolution of the banking system, how should a community bank be defined? (2) Are we pursuing the most appropriate approach to supervision and regulation of community banks, and finally, (3) How can we build a policy framework that better supports and anticipates this evolution of the banking system now and into the future?

[1] These remarks represent my own views and are not necessarily those of my colleagues on the Federal Reserve Board or the Federal Open Market Committee.

How to Define a Community Bank

By necessity, regulators divide banks into more manageable categories. The Federal Reserve has distinct portfolios that oversee "community," "regional," and four "categories" of larger banks.[2] The Federal Reserve and federal banking agencies further subdivide these portfolios based on additional factors. They may also depart from this framework altogether to group banks across portfolios or based on other common features.

This approach to separating bank supervisory portfolios can enable us to more clearly articulate the tailoring applied to specific requirements of supervision and regulation.[3] This approach has its virtues, including allowing examiners to better organize supervisory activities and training in different portfolios to focus on issues that are most relevant for the institutions being examined. When appropriately executed, it can lead to better and more risk-focused supervision, which ultimately promotes a safer and more sound banking system.

Of course, there are limits to this framework. And we should continue to ask if the metrics and thresholds established through regulation, and more often recently through supervisory policy decisions, are appropriate over time as conditions change.

Locking regulatory standards into a fixed asset-size threshold has its costs. Over time, these fixed thresholds fail to take into account growth attributable to broader economic growth

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[2] Larger banks are defined using tests that look primarily at asset size but may include other metrics like cross-jurisdictional activity, nonbank assets, short-term wholesale funding, or off-balance sheet exposures.

[3] For example, the "tailoring" rule in 2019 included a helpful visual that laid out the various standards and thresholds at which such standards applied across Category I-IV firms, and firms with more than $50 billion in assets. See Board of Governors of the Federal Reserve System, Tailoring Rule Visual, "Requirements for Domestic and Foreign Banking Organizations" (October 10, 2019), https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-visual-20191010.pdf. We use a variety of asset-size thresholds to help define our current portfolios and establish thresholds for supervisory and regulatory expectations. These thresholds apply for banks with assets of $10 billion, $50 billion, $100 billion, $250 billion, and $750 billion. Some regulatory standards implement lower thresholds under the current $10 billion community bank asset threshold. See, e.g., 12 C.F.R. 228.12 (defining a "small bank" and "intermediate bank" for purposes of the regulations implementing the Community Reinvestment Act); 13 C.F.R. 121.201 (SBA regulations defining small business entities, including commercial banks with less than $850 million in assets).

and inflation. They are also not reflective of any changes in a particular bank's activities or risk profile. As a result, many firms that are stable in their growth, business model, and risk profile end up unintentionally crossing regulatory thresholds. As they approach, and certainly once they cross over these asset-size lines, they must comply with additional regulatory and supervisory requirements that were specifically designed and implemented for larger and more complex firms.

While the fixed-threshold approach benefits from simplicity, it is necessary to periodically revisit the policy effect of these bright-line thresholds. There are certainly cases in which a bank with assets less than $10 billion faces risks that are disproportionate to its asset size, warranting greater supervisory scrutiny. For these firms, asset size may vastly understate their risk profile. Often, they do not operate like traditional community banks, relying instead on nontraditional services and engaging in complex activities. Therefore, it may be appropriate for a community bank to be subject to additional oversight. This is particularly relevant when a bank has un-remediated, long-standing supervisory issues that require more supervisory monitoring and oversight. In such cases, a community bank supervisory approach is likely not sufficient or appropriate.

At the same time, many banks with assets over $10 billion *do* operate like community banks, with a relationship-based straightforward business model, yet they are not regulated or supervised as such. Over time, the mismatch in supervisory expectations around this and other asset thresholds becomes more pronounced as economic growth and inflation effectively lower them. This results in potentially overly complex supervisory constructs for banks with a limited traditional community bank risk profile.

Is it appropriate to impose more restrictive requirements on firms when those heightened requirements are not a deliberate policy choice based on the level of risk? Is it appropriate to treat each bank below a regulatory threshold as a traditional community bank? Historically, regulators have been willing to push more complex requirements and expectations down to smaller banks—essentially bumping them into a higher risk tier—than moving larger firms into a lower risk tier when that treatment may be more appropriate.

One important aspect of this definitional question involves the natural evolution of banking, specifically as it relates to innovation. The "push down" of regulatory and supervisory standards often applies when a bank pursues activities that fit under the broad umbrella of "innovation." Innovation can be defined expansively to include engaging in bank-fintech partnerships, using (or considering using) digital ledger technology, or even providing traditional banking services to entities that touch the crypto-asset ecosystem. Innovation can present a challenging problem for both regulators and banks. If the "cost" of adopting innovation results in a bank's inclusion in a higher compliance tier, it may be difficult to encourage greater investment in innovation for smaller banks. Establishing appropriate regulatory thresholds does not force regulators to eliminate or purge innovation from the banking system, especially among community banks.[4]

When considering building a framework to support community banks, the definition is key—which banks will be in scope? The answer lies in the bank's business model, activities, and risk profile.

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[4] Michelle W. Bowman, "Innovation and the Evolving Financial Landscape" (speech at The Digital Chamber DC Blockchain Summit 2024, Washington, D.C., May 15, 2024), https://www.federalreserve.gov/newsevents/speech/files/bowman20240515a.pdf; Michelle W. Bowman, "Innovation in the Financial System" (speech at The Salzburg Global Seminar on Financial Technology Innovation, Social Impact, and Regulation, Salzburg, Austria, June 17, 2024), https://www.federalreserve.gov/newsevents/speech/files/bowman20240617a.pdf.

Where we have established fixed-dollar asset thresholds, we must commit to revisit and adjust them as needed. In my view, this is a principle that extends beyond the lines defining community banks to all regulatory and supervisory thresholds. While there is need for flexibility in both directions, it is apparent that over time economic growth and inflation will result in thresholds that are inappropriately low.

The Supervision and Regulation of Community Banks

Establishing a definition for community banks leaves open the fundamental question of regulatory and supervisory approach. Before turning to that discussion, we need to take stock of supervision and regulation today. What areas of the framework require review and attention?

The Tradeoffs of Regulation

Regulation can be a powerful and effective tool to promote bank safety and soundness, and U.S. financial stability. The special privileges that are granted with a banking charter—including deposit insurance and access to the discount window—all come with the responsibility and obligation to comply with the bank regulatory framework.

A robust presence of community banks, especially those that are remote and rural, enables access to credit, banking, and payment services in underserved markets and communities. These banks support local economies by serving consumers and small- and medium-sized businesses, building an economic foundation to drive business development and growth. But community banks, like any business, face the economic reality that accompanies running a successful business. Each must manage its costs—including personnel, funding, and regulatory compliance—in light of its revenues to achieve a reasonable return on equity.

When a bank's costs increase, there is, by necessity, a need to make changes if the bank hopes to maintain profitability and ultimately its survival. This usually involves either cutting costs or raising prices on banking services.

How do the realities of operating a business inform our current approach to regulation? The question becomes acutely relevant when regulators consider imposing new or revised regulations. Regulators should always ask (1) what problem does this new regulation solve, (2) what are costs of this approach, and (3) are there alternative approaches? Before discussing the path forward, I would like to note an example that highlights this concern.

The final Community Reinvestment Act (CRA) regulations issued in 2023 established new regulatory thresholds defining "small," "intermediate" and "large" banks, with the last category—large banks—including every bank with more than $2 billion in assets.[5] In my view, this rulemaking represented a missed opportunity to rationalize the requirements of the CRA among community banks, and ignored the fundamental differences among banks with different balance sheets and business models.[6] An approach that applies the same evaluation standards to a bank with $2 billion in assets as it does to a bank with $2 trillion in assets arguably represents a shortcoming in considering the fundamental differences among firms, and the disproportionate costs these standards may impose on the smallest banks.

The Hidden Cost of Supervision and Guidance

While regulation carries with it the obligation to comply with public notice and comment procedures under the Administrative Procedure Act, regulators have far more discretion in the

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[5] Community Reinvestment Act, 89 Fed. Reg. 6574 (February 1, 2024), https://www.govinfo.gov/content/pkg/FR-2024-02-01/pdf/2023-25797.pdf.

[6] See dissenting statement, "Statement on the Community Reinvestment Act Final Rule by Governor Michelle W. Bowman," news release, October 24, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20231024.htm.

supervisory process, and in issuing "guidance" that is technically non-binding but often operates as a de facto requirement. The development and implementation of new supervisory approaches and of guidance largely escape rigorous scrutiny due to the lack of formal procedural requirements for its development. This is true even though the expectations created by guidance can be equally or more impactful to banks than rules.

For example, the examination process often produces supervisory findings over-emphasizing non-core and non-financial risks, highlighting issues like IT and operational risk, management, risk management, and internal controls.[7] These issues have filtered down from examinations and findings at the largest banks to the smallest, raising the question of appropriateness of application for smaller firms.

In the supervisory process, we should guard against being distracted by less relevant issues. The prevalence of supervisory findings related to nonfinancial metrics is in part driven by the time it may take to remediate certain issues. However, we should also scrutinize whether this trend is indicative of our supervisory focus—beyond financial risk and toward non-financial risks and internal processes—and whether that shift is appropriate. We should also be aware that due to the vast diversity in business models, size, and geographic footprint among banks, we should not expect every firm to follow the same standards and must be careful to prevent forcing uniformity through "grading on a curve." This risk can be exacerbated through any type of horizontal-like reviews. The supervisory findings made during the examination process inform bank ratings, which can have follow-on effects like limiting options for mergers and acquisitions

[7] As noted in the Board's most recent Supervision and Regulation Report, nearly half of the 1,340 supervisory findings for community banks were cited in these categories, more frequently than credit risk as of the fourth quarter of 2023. See Board of Governors of the Federal Reserve System, *Supervision and Regulation Report*, (Washington: Board of Governors, May 2024) 22, figure 16, https://www.federalreserve.gov/publications/files/202405-supervision-and-regulation-report.pdf.

(M&A) activity; raising the cost of liquidity; or diverting resources away from other, more important bank management priorities.

Guidance can also impose costs on banks that are not always obvious or quantified. The purpose of guidance is to provide clarity to banks and reduce implementation uncertainty and risk. To serve this purpose, however, guidance must be clear, actionable, and account for the needs of the targeted firms, especially for community banks.

In 2023, the federal banking agencies published supervisory guidance addressing third-party risk management, guidance expressly applicable to community banks. As I noted at the time this guidance was issued, it included shortcomings that were known and identified, but not addressed in advance.[8] While I am pleased that the community bank implementation guide was eventually published, this recent example demonstrates that we need to ensure new guidance provides clarity to regulated firms on its own, or that we provide additional resources at the same time we publish the guidance.

Guidance can help clarify uncertainty about the application of legal requirements or suggest how regulators may view particular activities in the supervisory process. But when guidance is unclear or ambiguous about supervisory views and expectations, it can hinder community banks' ability to clearly understand and meet them. Community bankers feel a strong obligation to review the voluminous body of guidance published by regulators, knowing

[8] Michelle W. Bowman, "Defining a Bank" (Speech to the American Bankers Association 2024 Conference for Community Bankers, San Antonio, Texas, February 12, 2024), https://www.federalreserve.gov/newsevents/speech/files/bowman20240212a.pdf; Statement on Third Party Risk Management Guidance by Governor Michelle W. Bowman (June 6, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230606.htm ("… Federal Reserve regional bank supervisors have indicated that we should provide additional resources for community banks upon implementation to provide appropriate expectations and ensure that small banks understand and can effectively use the guidance to inform their third-party risk management processes…. I am disappointed that the agencies failed to make the upfront investment to reduce unnecessary confusion and burden on community banks").

that even where it does not apply to them on its face, it may be pushed down to these banks as a best practice in the future.[9]

Bank Mergers, Acquisitions, and De Novo Formations

What does a healthy banking system look like? While we often espouse the virtues of a "diverse" banking system—one with many different sizes of institutions and the flexibility to shift in size over time—a healthy banking system includes opportunities for entry and exit—from de novo bank formation through merger and acquisition activity.

De novo bank formation promotes competition and greater availability of banking services. As banks consolidate or wind down operations, new banks fill gaps in the banking system. But the significant decline in the number of de novo banks raises questions about whether this pipeline can continue to be effective, even while there is existing and unmet demand for new charters.[10] While factors other than the regulatory climate for applications may influence bank formation, the application process itself can be a significant roadblock, one that can limit the healthy formation of new community banks. For example, the M&A approval process can have a disproportionate impact on community banks because the "screens" used to evaluate the competitive effects of a proposed merger often result in a finding that a rural market M&A is

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[9] As I have noted in the past, even guidance with an applicability "threshold" may effectively establish new expectations even for much smaller banks. Michelle W. Bowman, "Tailoring, Fidelity to the Rule of Law, and Unintended Consequences" (speech at the Harvard Law School Faculty Club, Cambridge, Massachusetts, March 5, 2024), https://www.federalreserve.gov/newsevents/speech/files/bowman20240305a.pdf ("[w]hen guidance notes that 'all financial institutions, *regardless of size*, may have material exposures to climate-related financial risks…,' my intuition is that banks will take little comfort from the nominal carveout [of banks with less than $100 billion in assets] in light of this language….").

[10] See Michelle W. Bowman, "Bank Mergers and Acquisitions, and De Novo Bank Formation: Implications for the Future of the Banking System" (speech at A Workshop on the Future of Banking, Hosted by the Federal Reserve Bank of Kansas City, Kansas City, Missouri, April 2, 2024), https://www.federalreserve.gov/newsevents/speech/files/bowman20240402a.pdf.

"anticompetitive."[11] Even when these transactions are eventually approved, the mechanical approach to analyzing competitive effects, which isolates deposits as the proxy for the bundle of banking services, results in many delays for M&A transactions involving community banks or requiring additional review and analysis.

Some recent policy changes at the FDIC have signaled a growing awareness of the need to better recognize a broader range of competition. But I am concerned that fully pivoting to a segment-by-segment analysis of competitive effects could, in practice, result in greater opportunities for regulatory *objection* to transactions, rather than as a mechanism to better reflect the competitive pressures for community banks. Replacing the deposit-based threshold to analyze competition with a completely open-ended approach—without standards for what products will be reviewed, what standards to apply for different products, and how to approach a transaction where the competitive impacts vary by product type—seems likely to promote inconsistency in the analysis among firms, and even longer delays in processing times. This is especially concerning when accompanied by changes that may result in even greater barriers to M&A regulatory approval.[12]

Fostering an environment that enables bank formation and merger transactions is vital to ensuring a future for community banking. Without viable formation and merger options for all banks, but especially for community banks, we will create a "barbell" in the banking system. If this continues, it will eventually result in a handful of very large banks, and an ever-shrinking

[11] Michelle W. Bowman, "The Role of Research, Data, and Analysis in Banking Reforms" (speech at the 2023 Community Banking Research Conference, St. Louis, Missouri, October 4, 2023), https://www.federalreserve.gov/newsevents/speech/files/bowman20231004a.pdf; Michelle W. Bowman, "The New Landscape for Banking Competition," (speech at the 2022 Community Banking Research Conference, St. Louis, Missouri, September 28, 2022), https://www.federalreserve.gov/newsevents/speech/files/bowman20220928a.pdf.

[12] FDIC, "Final Statement of Policy on Bank Merger Transactions," (September 17, 2024), https://www.fdic.gov/system/files/2024-09/final-statement-of-policy-on-bank-merger-transactions.pdf.

number of community banks, with nothing left in the middle. Over time, these trends will result in a reduction in available credit and services, an increase in the number of unbanked or underbanked communities, and economic harm.

Building a Framework to Better Support Community Banks

After acknowledging the importance of community banks and effectively defining these firms, the next step is identifying principles for how these firms should be regulated and supervised. The guiding principles are relatively straightforward: the approach must be tailored to risk, transparent, and consistent across similar institutions. Together, these elements can create an opportunity to construct an enduring community bank regulatory and supervisory framework for the future.

This conference provides an ideal venue to facilitate conversations that can help spur the development of blue-sky ideas to preserve community banking well into the future. While it would be impossible to lay out a comprehensive blueprint for a community banking reform agenda in this speech, I see several opportunities that are promising and essential.

The Value of Experience

Building this framework for the future starts with personnel, the people making decisions over the long term. How do we approach our responsibilities? We should highlight examples that have been successful but also reflect on the significant work that remains to be done.

Congress reserved one seat on the Federal Reserve Board for someone with demonstrated primary experience working in or supervising community banks.[13] While Congress did not enumerate any specific additional responsibilities for this particular seat on the Board, the

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[13] 12 U.S.C. § 241.

creation of this role itself is an implicit acknowledgement of the value that this experience can bring across the Board's functions, especially regarding bank regulation and supervision.

This experience, of having worked as a banker or as a state regulator, is uncommon within the Federal regulatory agencies. For example, of the current members of the Federal Reserve Board, I am the only member with experience as a banker or state regulator. In my view, we should ask how someone with this experience in the community banking system can best serve on the Board.

This experience and perspective is critical. As a former community banker at a state-chartered bank and as the State Bank Commissioner of Kansas, I have seen and directly experienced the practical effect of supervision and regulation from "both sides" of the banker's desk. With this background, one understands and appreciates the importance of a respectful and healthy partnership between state and federal regulators and the need for setting high standards and applying strong oversight to banks of all sizes, including community banks. This background also provides perspective on how overregulation can impose disproportionate burden on a community bank, over time leading to the erosion of the viability of the community banking model.

The requirement for community banking experience does not equate to advocacy on behalf of community banks. Instead, this role provides much-needed perspective on—and calls attention to—bank regulatory and supervisory matters that affect community banks.

When I arrived at the Board, I was designated to serve as the chair of the Subcommittee on Smaller Regional and Community Banking. One of my first priorities was to make clear to examination staff the importance of their work in supervising community banks. After the 2008 financial crisis, although many community banks failed, much of the supervisory attention

shifted to the very largest firms. The focus of this role provided the platform and opportunity to prioritize small regional and community banking issues, which led to a number of important successes, including:

- the creation of the Small Bank Supervision Working Group to focus on the unique issues facing small banks with Reserve Bank staff from across the system;
- the development and implementation of tools to assist community banks in complying with the Current Expected Credit Losses ("CECL") reporting change;
- as interest rates were rising, encouraged supervisory focus to develop examination guidance to assess the risks associated with a changing interest rate environment and low tangible common equity, well before the spring 2023 banking failures;
- improved frequency and content of communication with community banks; and
- during the COVID-19 response, worked together with agency partners to implement approaches that encouraged banks to work with their borrowers, suspend exam timelines, and extend reporting deadlines for affected banks. During that time, staff also developed guidance for examiners as we emerged from the pandemic.

These accomplishments highlight how prioritizing community banking issues at the highest level can improve the outcomes and experiences for community banks. We need a balanced approach to regulation and supervision of community banks. This approach should prioritize the key risks facing the banking system, acknowledge the costs of regulation and supervision, and consider alternatives that may be more efficient than simply adding additional requirements and expectations for smaller institutions.

While I am proud of these accomplishments and our work together, a more formal structure for this seat's responsibilities—one that includes dedicated responsibility over the

supervision and regulation of community banks, and to play an active role in interagency coordinating bodies like the Federal Financial Institutions Examination Council (FFIEC)—would go a long way toward building and preserving an enduring framework that supports community banks in the future.

State Coordination

One priority that would enhance our current approach to supervision would be to more effectively engage and coordinate with state banking regulators. What does coordination look like in practice? As a baseline, it should include communication during the consideration of regulatory proposals. But let's begin with the examination process. One of the concerning trends in 2023 were reports—including reports from state banking regulators—that some federal supervisory actions were excessive considering the risks posed by some smaller institutions.[14] Historically, such disagreements have been uncommon because the examination process for state-chartered banks is joint between the state and federal counterparts at the Fed or the FDIC. We share responsibility for oversight of state banks, and jointly participate in examinations, so it is unsurprising that we often reach similar conclusions. When there are disagreements, supervisory divergence can also signal material changes in approach or standards, a shift that fails to accomplish the goal of effective supervisory judgment and consistency in the supervision of banks of all types.

There are other opportunities to expand coordination with states, both through formal coordination bodies and when engaged in rule making efforts that are intended to impact state-

[14] Michelle W. Bowman, "Defining a Bank," (speech at the American Bankers Association 2024 Conference for Community Bankers, San Antonio, Texas, February 12, 2024), https://www.federalreserve.gov/newsevents/speech/files/bowman20240212a.pdf; 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/files/bowman20240108a.pdf.

chartered institutions. These coordination bodies include (1) the FFIEC—which is tasked with prescribing uniform principles, standards, and reporting forms for the federal examination of financial institutions, and making recommendations to promote consistency in the supervision of financial institutions—and (2) the Financial and Banking Information Infrastructure Committee—which is tasked with promoting information sharing and enhancing incident response planning, in addition to identifying cybersecurity best practices.

Coordination is only effective if we are committed to work in an open, collaborative, and balanced way with other agencies and policymakers. There are unmet opportunities on this front. For example, the FFIEC is the venue in which regulators coordinate on examination standards and discuss and agree on reporting requirements that apply to smaller banks. With a growing divergence in the approach of state and federal regulators to the examination process, we need to ask how the FFIEC can better accomplish its goals.

We also need to ask whether the other important work of the FFIEC, like establishing reporting requirements, is being conducted in an appropriate way. The opportunities for input, review, and oversight of this important work are very limited, with only the Board representative on the FFIEC participating. Notwithstanding these structural impediments, I have prioritized rationalizing the Call Report, an effort that I revived when I joined the Board.

These types of overly broad requirements pose their own risks to community banks, and we should remember to focus on the unglamorous work of making sure we are not collecting more data than is necessary and appropriate for supervisory purposes, and that we are efficient in the collection of that data, for example, by leveraging data previously collected instead of requiring further collection of the same data.

Regulators also tend to be very proprietary about the development of regulatory and supervisory proposals. Often, policies are far along in the development process before they are published for public comment in the rulemaking process, and state banking regulators rarely provide feedback on proposals before or after they are put out for comment.

While regulators tasked with implementing regulations, supervision, and guidance bear the ultimate responsibility for those policy choices, this process can greatly benefit from more interaction among federal regulators and our state bank regulatory counterparts. More extensive dialogue with state regulators can improve proposals in the formulation stage by sharing practical, real-world perspectives, including observations on the impacts of intended and unintended consequences. While it is challenging to anticipate the unintended consequences of reforms, casting a wide net for views can lead to better, less disruptive, and better-informed policy choices.

The importance of enhancing coordination between state regulators and the Federal Reserve cannot be overstated. At a recent meeting of the Board's Subcommittee on Smaller Regional and Community Banking, my colleagues and I were delighted to welcome representatives of the Conference of State Bank Supervisors and four of their State Bank Commissioner members. We learned firsthand about the successes, frustrations, concerns, and areas for improvement in the coordination between state and federal regulators. There is simply no substitute for these direct conversations and building upon and improving these important intergovernmental relationships.

Collaborative Approach to Reform

Historically, one of the many virtues of the Federal Reserve Board is the structural incentive to work together to achieve compromise. Governors serve extended, staggered terms

intended to insulate them from political considerations. The Board consists of seven independent governors who often bring their unique voices to a range of policy matters. While instances of dissent tend to attract the most attention, the Fed has a long history and tradition of engaging in thoughtful debate, exchange of views, and reaching more durable compromises on rulemaking matters. The history of consensus on bank regulatory matters is not surprising because we work toward common goals of safety and soundness and financial stability.

Consensus is a powerful tool. When there is broad policy agreement, there tends to be moderation in approach, acting as a check on wild swings of the regulatory pendulum and providing banks and holding companies with an important degree of stability in their regulatory and supervisory expectations. While it is important for regulators to adapt to changing conditions, and to evolve in the face of new and emerging risks, this incremental approach tends to produce better policy and better outcomes in the banking system.

The antithesis of this policymaking approach is one that involves the close guarding of information, limiting the airing of competing views, and failing to engage in meaningful discussion and debate about policy. When contrasting these two ends of the policymaking spectrum, the virtues of consensus-building are even more apparent. Regulatory reform should not be a "shock" to the banking system, and meaningful discussion and consensus act as a check on dramatic swings of the regulatory pendulum.

Collaborative reform is more effective when we have both a widespread sharing of information, analysis, and policy perspectives, and when a range of views is brought to bear on important regulatory questions. One way that we can accomplish this goal is through representation of those with banking or state regulatory experience representing the Federal Reserve in bodies that are influential in the shaping of policy approaches, like the FFIEC, and by

embracing a culture of freely sharing information among policymakers both within and across regulatory agencies.

Assessing the Costs and Benefits of Existing Approaches and Reform

Too often when regulators impose requirements on banks, the temptation is to overestimate the benefits and underestimate the costs. Requiring banks to report additional data allows us to better understand the operations of banks. Limiting the fees that may be charged to consumers may result in a short-run reduction in consumer costs. But in the long run, regulation carries with it many costs, ranging from the direct costs of compliance and capital to indirect costs like the reduction in product offerings or increased prices for consumers. Regulators must anticipate, assess, and balance these costs in the rulemaking process and accept that, at times, the right policy is not to impose additional regulations but rather to take actions to reduce the burden of existing regulatory requirements.

One of the key challenges to pursuing this balancing is how to effectively complete the analysis. The incremental burden of any single regulatory reform may be challenging to measure—its costs may seem minor when weighed against the benefits. But this approach ignores the additional cost of *cumulative* burdens, a concern that is particularly acute among community banks faced with an onslaught of changes.

If we ignore cumulative burdens, we risk more rapid and pronounced swings in the regulatory pendulum. These swings in approach risk not only our ability to effectively supervise banks, but banks' ability to effectively manage their business.[15] When faced with regulatory change, how does bank management review and provide meaningful comment on voluminous

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[15] Michelle W. Bowman, "Bank Mergers and Acquisition, and De Novo Bank Formation: Implications for the Future of the Banking System," (speech at a Workshop on the Future of Banking hosted by the Federal Reserve Bank of Kansas City, Kansas City, Missouri, April 2, 2024), https://www.federalreserve.gov/newsevents/speech/files/bowman20240402a.pdf.

concurrent regulatory proposals that may build upon proposed, but not finalized regulations? When new rules are adopted, how can a bank ensure it has appropriate staffing and resources to ensure compliance?

The cumulative burden of regulation is rarely acknowledged in the rulemaking process. While we assess burden with respect to discrete rule changes, there is no obligation to "refresh" that analysis due to changes in underlying conditions or new information about impact absent a further rule change. And the analysis of a rule focuses on the *incremental* impact of the specific regulation, ignoring the likely aggregate effect of requirements.

While the minimum legal process required under the Administrative Procedure Act should be the "floor" for rulemaking, in my view it is insufficient. Likewise, while policymakers have even greater discretion in pursuing changes to supervision, we need not do so in a vacuum without opportunities for—and a receptiveness to—feedback. We can and should expand the lens through which we consider proposals, in a way that considers the cumulative effects of regulation and supervision on banks and their ultimate customers, in a way that identifies redundancies and excessive burdens, and in a way that considers multiple alternatives and the tradeoffs of different approaches.

Tailoring

Finally, I would be remiss to discuss the future of community banking without noting one of the critical mechanisms to build a sensible framework for the future—tailoring. Tailoring helps us calibrate regulation and supervision to the activities and risks at every tier within our oversight framework, but it is particularly important when we think about the application of prudential tools to community banks. Tailoring our approach helps with the allocation of finite resources—among both banks and regulators. It enables us to right-size the approach to

regulation and supervision to the complexity of banks, acknowledging that community banks that pose manageable risks in the event of their failure, and no real risk to financial stability, simply do not warrant the same treatment as larger, more complex, and more systemically interconnected banking institutions.

While in some cases, policymakers have made efforts to promote appropriate tailoring, often the end result has been lacking. As I noted earlier, in my view the 2023 CRA reforms represent a missed opportunity to rationalize and right-size CRA requirements for community banks. Instead, the rule applied the same essential framework to all institutions above $2 billion in assets, scoping in community banks with the very largest global systemically important banks. Even where supervisory approaches take into account the needs of community banks, the end result requires reviewing and incorporating ever-increasing guidance into their risk management activities. This was certainly the case with regulatory guidance on third-party risk management.

To be clear, tailoring is not only an efficient way to allocate resources, but the lack of tailoring poses a longer-term threat to the viability of community and smaller banks. As the banking system evolves, with new opportunities and new risks, the temptation is to simply increase the body of regulatory requirements, without doing the necessary work of "maintenance," to ensure that the set of requirements that applies to banking activities is appropriate.[16]

Often, our guidance has a "cumulative" or "compounding" effect—a bank cannot go to a single source or compendium to understand supervisory expectations or requirements for a particular activity. Instead, a banker must parse through multiple regulations and guidance

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[16] The banking agencies have an obligation under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 to review their regulations every 10 years to identify, with input from the public, outdated, unnecessary, or unduly burdensome regulation and to consider how to reduce regulatory burden. See 12 U.S.C. § 3311.

before understanding how regulators expect an activity to be conducted. A community banking regulatory framework that enables small banks to thrive must prioritize tailoring.

Closing Thoughts

Thank you for your commitment to community banking, and conducting the important research that can inform the regulatory policy agenda. Community banks may be small but their contributions to local communities are mighty. The importance of their role in providing credit to a broad range of customers and businesses that in their absence would have far fewer banking options cannot be overstated.

There simply is no alternative or replacement for community banks and the relationship banking model. If regulators believe in a dynamic banking system, if we support financial inclusion and extending the availability of banking access, we must acknowledge the importance of community banks and ensure that our regulatory framework preserves their role for the future. To function effectively, the banking system requires the presence of banks of all sizes—larger, regional, and community banks. This diversity of our financial institutions is the greatest strength of our banking system, and it can easily be imperiled by insufficiently targeted regulation, supervision, and guidance.

The discussions we will have over the next two days will include steps to further preserve and enhance the future of community banking. The presentations will enhance our understanding of the dynamics and pressures that shape the banking system, identify issues and concerns that may threaten different bank business models and activities, and develop policy approaches that consider the tradeoffs in our regulatory and supervisory approach.