Perspectives on the Economic Outlook and Banking Supervision and Regulation

Loretta J. Mester
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

The Community Bankers Association of Ohio Annual Convention
Cincinnati, OH

August 2, 2017

Introduction

I thank the Community Bankers Association of Ohio for the opportunity to speak at your annual convention and for your ongoing engagement with the Federal Reserve. That engagement actually goes back to the very beginnings of the Federal Reserve System. It might surprise some of you to know that in 1913, Elvadore Fancher, a vice president with Union National Bank of Cleveland, wrote to Congress suggesting how the regional Reserve Banks might be structured. A year later, Fancher was chosen to be the first head of the Federal Reserve Bank of Cleveland, a position in which he served for two decades.[1] Today, I enjoy the fruits of the strong relationship that has developed between Ohio bankers and the Cleveland Fed. The bankers who serve on our Community Depository Institutions Advisory Council (CDIAC) and on our board of directors generously provide me with their valuable insights into regional economic and banking conditions. As you all know, community banks play a vital role in the economic health of their communities, providing creditworthy businesses the wherewithal to prosper and households the ability to improve their financial standing and quality of life. Because of their important work, community bankers are among the most knowledgeable about changes in conditions on the ground in local areas. Such information often takes much longer to show up in official statistical reports. So I find the insights gained from speaking with bankers to be especially valuable as part of the mosaic of information I use in formulating my views on appropriate monetary policy.

Of course, from time to time, I also hear from community bankers about matters pertaining to banking regulation and supervision. Recently, these conversations have highlighted the burden of the regulatory changes put in place since the financial crisis. I am grateful to the bankers who willingly discuss both the economy and regulation with me, and today I would like to return the favor and provide you with some of

[1] For further information about Elvadore Fancher, see https://www.federalreservehistory.org/people/elvadore_r_fancher.

my perspectives on both. Of course, the views I'll present today are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

The Economic Outlook and Monetary Policy

The economic expansion turned eight years old this summer. It got off to a slow start from a very weak place, but now this expansion is one of the longest on record. The sustainability of the expansion through various economic shocks is a testament to the U.S. economy's resiliency, and I believe the underlying fundamentals supporting the economic expansion remain sound. While the quarterly pattern has had its share of ups and downs, it is usually a good idea to smooth through this volatility when trying to assess underlying conditions. Over the expansion, output growth has maintained a moderate pace of a bit more than 2 percent, on average. This year, growth in the first quarter was a bit soft, but it picked up in the second quarter. Favorable fundamentals should support GDP growth over the next year at somewhat above trend, which I estimate at 2 percent. These fundamentals include accommodative monetary policy and financial conditions, a sound U.S. banking system, improved household balance sheets and income growth, continued strength in the U.S. labor market, and improving conditions in the economies of our trading partners.

In 2016, the economy added over 2.2 million jobs, about 187,000 per month on average. So far this year, that strength has been sustained, with an average increase of 180,000 jobs per month. The pace is well above estimates of trend employment growth, which range from around 75,000 to 120,000 per month, depending on what one assumes about labor force participation. The trend pace of employment growth is lower than it was a few decades ago because there has been a downward trend in participation, reflecting demographic factors, including the aging of our population. The fact that the participation rate has been basically stable for the past three years in the face of a declining trend is another sign of strength in the labor market.

Over the expansion, as the economy has added jobs, the unemployment rate has been moving down. The unemployment rate peaked at 10 percent after the Great Recession. In June, it stood at 4.4 percent, matching the lowest level reached in the previous expansion. In addition, broader measures of the unemployment rate, which track the number of part-time workers who would rather work full time and the number of people who have been discouraged from looking for a job, have also fallen significantly since their business cycle peaks. Given the progress that has already been made, payroll job growth is likely to slow a bit from its current pace, but I expect that over the next year the unemployment rate will stay below my estimate of its longer-run rate, which I now estimate at 4-3/4 percent. I recently lowered my estimate from 5 percent, and even though this change is not statistically significant, I thought it was time to acknowledge that even as labor markets continue to tighten, inflation has remained moderate.

Inflation has had its ups and downs over the expansion. It has moved up from the very low levels seen in 2015 when it was held down by falling oil and import prices. But the last couple of readings were on the weak side and inflation continues to run below the Fed's goal of 2 percent. In assessing where we are relative to the goal, it's always a good idea to look through transitory movements in the numbers, both those above and those below our goal, and focus on where inflation is going on a sustained basis. Some of the weakness in recent inflation reports reflects special factors, like the drop in the prices of prescription drugs and cell phone service plans. It may take a couple of months for these factors to work themselves through, but these types of price declines aren't signaling a general downward trend in consumer prices. I'll be scrutinizing incoming inflation data and reports from my business contacts, but at this point, my assessment is that the conditions remain in place for inflation to gradually return over the next year or so to our symmetric goal of 2 percent on a sustained basis. These conditions include growth that's expected to be at or slightly above trend, continued strength in the labor market, and reasonably stable inflation expectations.

Based on the economic outlook and risks around the outlook, the Fed has begun to normalize the stance of monetary policy by removing some of the extraordinary accommodation that was necessary in the wake of the financial crisis and Great Recession. Appropriate adjustments in monetary policy are those that will sustain the expansion so that our longer-run goals of price stability and maximum employment are met and maintained. We can't wait until the goals are fully met because monetary policy affects the economy with a lag. We need to remain focused on the medium-run outlook, and risks around the outlook, assessing what incoming economic reconnaissance implies about the outlook and risks. If economic conditions evolve as anticipated, I believe further removal of accommodation via gradual increases in the fed funds rate will be needed.

The gradual path that the FOMC has communicated for some time is appropriate given the outlook will help prolong the expansion, not curtail it. A gradual removal of accommodation helps avoid a build-up of risks to macroeconomic stability that could arise if the economy is allowed to overheat, as well as risks to financial stability if interest rates remain too low and encourage investors to take on excessively risky investments in a search for yield. The gradualism has allowed us to follow a consistent strategy even as the data on the economy and inflation have shown some fluctuations. I see benefits to this consistency: it removes some ambiguity and it underscores the fact that we set monetary policy systematically, with a focus on the medium-run outlook and risks around the outlook and their implications for our policy goals.

It's important to notice that the gradual path I anticipate does not entail an increase at each FOMC meeting, and last week, the Committee decided to maintain the target range for the federal funds rate at 1 to 1-1/4 percent; it also announced that economic conditions are expected to evolve in a way that will warrant further gradual increases.

Normalizing the stance of monetary policy also means taking steps to normalize the Fed's balance sheet in terms of the size and composition of assets. The balance sheet grew when, to address the Great

Recession, the Fed undertook several programs to purchase longer-term assets, including longer-maturity Treasuries and agency mortgage-backed securities (MBS). These purchases aimed to put downward pressure on longer-term interest rates once the FOMC's traditional policy tool, the fed funds rate, had been reduced to effectively zero. As a result of the purchases, the Fed's balance sheet has grown from nearly $900 billion in assets in 2007 to about $4.5 trillion today, and its composition has changed from mainly short-term Treasury securities to mainly longer-maturity Treasuries and agency MBS.

From the very start of using the nontraditional tools, the FOMC recognized it would need to eventually return to a more normal balance sheet. In June, the FOMC described its program for normalizing the balance sheet by gradually reducing the amount of reinvestments it is making in a predictable way.[2] Last week, the FOMC said it expected to begin implementing the program relatively soon.[3]

Once started, the plan is to allow up to $6 billion a month of maturing Treasuries and $4 billion a month of principal payments of agency MBS and agency debt to run off the balance sheet. These caps would be increased by $6 billion and $4 billion per month, respectively, every three months, until they reach $30 billion per month for Treasuries and $20 billion per month for agency MBS and agency debt. Thereafter, those caps would be maintained and the balance sheet would gradually decline. The gradual, predictable decline allows balance-sheet normalization to run in the background and monetary policy to focus on setting the appropriate level of the funds rate, our conventional monetary policy tool.

Regarding the ultimate size of the balance sheet, the intention is to reduce it over time to the smallest size needed to implement monetary policy efficiently and effectively. We know the balance sheet will be

---

[2] See "FOMC Issues Addendum to the Policy Normalization Principles and Plans," Board of Governors of the Federal Reserve System press release, June 14, 2017 (https://www.federalreserve.gov/newsevents/pressreleases/monetary20170614c.htm).

[3] See the FOMC post-meeting statement of July 26, 2017 (https://www.federalreserve.gov/newsevents/pressreleases/monetary20170726a.htm).

larger than it was prior to the financial crisis for the simple reason that the public's demand for currency is rising over time.[4] But it will also likely be considerably smaller than it is today. Just how much smaller depends on how the FOMC implements monetary policy in the future. The FOMC has not yet decided whether its long-run framework will be one in which bank reserves are scarce, as was the case before the financial crisis, or one in which reserves are abundant.[5] However, because it will take several years to reduce the size of the balance sheet through asset run-off, the FOMC can begin normalizing the balance sheet before we have decided on the balance sheet's ultimate size.

It's important to remind everyone that there are risks around the economic outlook, and because of that, monetary policy is not pre-set. In March, the FOMC began providing confidence bands around its economic and policy path projections.[6] These are visual reminders to both the public and policymakers that there is always a lot of uncertainty around economic forecasts. Policy needs to remain systematic in how it reacts to incoming information relevant to the outlook, but not be dogmatic should the outlook indeed materially change. That said, I view the steps the FOMC is taking to normalize monetary policy –

---

[4] Since the financial crisis, currency has doubled in quantity, from about $770 billion in 2007 to about $1.5 trillion today. For projections of the Fed's balance sheet, see "Projections for the SOMA Portfolio and Net Income," Federal Reserve Bank of New York, July 2017 (https://www.newyorkfed.org/medialibrary/media/markets/omo/SOMAPortfolioandIncomeProjections_July2017Update.pdf).

[5] For an accessible description of frameworks for implementing monetary policy, see Jane E. Ihrig, Ellen E. Meade, and Gretchen C. Weinbach, "Rewriting Monetary Policy 101: What's the Fed's Preferred Post-Crisis Approach to Raising Interest Rates?" *Journal of Economic Perspectives* 29 (Fall 2015), pp. 177-198 (http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.29.4.177).

For discussions of the pros and cons of different frameworks for implementing monetary policy, see George A. Kahn, "Monetary Policy Under a Corridor Operating Framework," *Economic Review*, Federal Reserve Bank of Kansas City, Fourth Quarter 2010 (https://www.kansascityfed.org/publicat/econrev/pdf/10q4Kahn.pdf); Todd Keister, "Corridors and Floors in Monetary Policy," *Liberty Street Economics*, Federal Reserve Bank of New York, April 4, 2012 (http://libertystreeteconomics.newyorkfed.org/2012/04/corridors-and-floors-in-monetary-policy.html); and Ben S. Bernanke, "Should the Fed Keep its Balance Sheet Large?" Brookings Institution Blog, September 2, 2016 (https://www.brookings.edu/blog/ben-bernanke/2016/09/02/should-the-fed-keep-its-balance-sheet-large/).

[6] See the confidence band charts in the Summary of Economic Projections portion of the Minutes of the Federal Open Market Committee, March 14-15, 2017 (https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20170315.pdf).

both the fed funds rate and the balance sheet – as a welcome acknowledgment that the economy is transitioning back to normal after being in the abyss of the financial crisis and Great Recession.

Financial System Regulation

As everyone in this room knows, the crisis and its aftermath were very dark times for households, businesses, banks, and policymakers. That the financial system was at the heart of the crisis attests to the fact that a sound financial system is a vital part of a vibrant economy. The 2008 financial crisis exposed gaps in the regulatory and supervisory architecture in the U.S., which contributed to a buildup in financial imbalances and systemic risk. In response to the crisis, changes were made to how banks are regulated and supervised, and banks themselves have made changes in how they monitor risks and run their businesses. As a result, the U.S. financial system is considerably stronger and more resilient than it was leading up to the financial crisis. This strength and resiliency benefit the economy and must be preserved.

However, just as the improved economy affords us the opportunity to begin to normalize monetary policy, the improved health of the banking industry makes this an opportune time to consider whether any adjustments to the regulatory and supervisory framework could make it even more effective. I won't keep you in too much suspense: the Federal Reserve and the other financial regulatory agencies are already taking steps to improve the effectiveness of their supervision. Before I discuss some of the steps that are particularly relevant for community banks, it might be helpful to review why banks are regulated and the basic approach to effective regulation.

A risk-based approach to bank regulation and supervision

Banks play an important role in the economy by providing funding to creditworthy borrowers, both businesses and households, by offering customers methods to save and make payments, and by helping people and firms manage their financial affairs. Community banks play a crucial role in their local economies, and particularly so in many small towns and rural areas where the choices of financial services are limited.[7] Small businesses rely heavily on community banks for credit, and given the important role that small businesses play in the economy, it isn't hard to see that serving these types of firms helps to promote growth.[8] In addition, community banks tend to have close ties to the communities and customers they serve, and this allows them to offer products and services tailored to their customers' needs.[9]

But banks of all sizes are able to provide these valuable credit, payment, and financial management services because they are designed to take risks and are highly leveraged compared with nonfinancial businesses. This risk-taking and leverage raise the possibility of systemic problems that could threaten the functioning of the financial system, hurt real economic activity, and impose significant economic costs. The bank regulatory and supervisory framework is meant to address the potential problem of systemic risk, as well as the safety and soundness of individual institutions. The framework aims to foster a financial system that's resilient: one in which financial institutions remain strong enough to continue to lend and offer other valuable services through the ups and downs of the business cycle.

[7] See, for example, "The Role of Community Banks in the U.S. Economy," Federal Reserve Bank of Kansas City *Economic Review*, Second Quarter 2003, pp. 15-43 (https://www.kansascityfed.org/Publicat/econrev/Pdf/2q03keet.pdf).

[8] Three-quarters of U.S. businesses have fewer than 10 employees. Over a quarter of U.S. private-sector jobs are at firms with fewer than 50 employees, and over half are at firms with fewer than 500 employees (based on data from supplemental tables F and G of the National Business Employment Dynamics Data, U.S. Bureau of Labor Statistics, available at http://www.bls.gov/bdm/bdmfirmsize.htm). For further discussion of the role small businesses play in the U.S. economy, see Loretta J. Mester, "The National and Regional Economic Outlook and Monetary Policy," remarks at the African American Chamber of Commerce of Western Pennsylvania Annual Business Luncheon, Pittsburgh, PA, November 30, 2016 (https://www.clevelandfed.org/newsroom%20and%20events/speeches/sp%2020161130%20the%20national%20and%20regional%20economic%20outlook%20and%20monetary%20policy).

[9] See Allen N. Berger and Gregory F. Udell, "Small Business Credit Availability and Relationship Lending: The Importance of Bank Organisational Structure," *Economic Journal* 112, February 2002, pp. 32-53 (working paper version available at https://www.federalreserve.gov/pubs/feds/2001/200136/200136pap.pdf), and Allen N. Berger, Christa Bouwman, and Dasol Kim, "Small Bank Comparative Advantages in Alleviating Financial Constraints and Providing Liquidity Insurance Over Time," *Review of Financial Studies*, forthcoming (working paper version available at http://sc.edu/study/colleges_schools/moore/documents/finance/berger/small_bank_comparative_advantages.pdf).

Post-crisis regulatory changes focused on increasing resiliency in two ways: first, by lowering the probability of another financial crisis, and second, by reducing the costs imposed on the rest of the economy when a shock hits the financial system. Important components of the regulatory-supervisory framework include capital requirements, liquidity requirements, stress tests, living will resolution plans, and resolution methods that allow systemically important institutions to fail without causing problems for the entire financial system.

The focus on risk management means that institutions that pose the most systemic risk should face enhanced prudential standards and supervisory attention. The Dodd-Frank Act took a step in this direction and the Federal Reserve takes a tiered approach to banking supervision. Aligning oversight with risk helps to ensure that institutions aren't burdened by rules that make it more costly for them to serve their customers but that do little to further the goal of a healthy and resilient financial system. Community banks generally don't impose costs on the rest of the financial system or create the kinds of contagion that can put the entire financial system at risk, so their oversight should differ from that of systemically important institutions. At the same time, as the savings and loan crisis in the 1980s and the commercial real estate crisis in the late 1980s and early 1990s remind us, when many smaller institutions get in trouble at the same time, this can also harm the economy. So maintaining the safety and soundness of smaller institutions cannot be neglected. It's a matter of aligning oversight with potential risk.

Steps to reduce the regulatory burden on community banks without sacrificing financial resiliency, safety, and soundness

This tiering of oversight by risk adds some complexity to the financial system's regulatory framework. But the U.S. financial system is quite complex and ever-changing, with various types of banks and nonbank providers of financial services. So some complexity is to be expected. To paraphrase H.L. Mencken: "For every complex problem there is a solution that is clear, simple, and wrong." That said, it's important that the regulatory framework avoid excessive complexity, which can complicate supervision, risk monitoring, compliance, and enforcement. Too much complexity can make it harder for banks to understand the standards they are being asked to meet, and harder for regulators to assess compliance and overall risk. Better aligning our regulation and supervision with the risks imposed could allow simplifications without sacrificing safety, soundness, and resiliency.

The Volcker rule is perhaps an obvious example of this. Dodd-Frank generally limits banks from engaging in proprietary trading of financial instruments and investing in hedge funds and private equity funds. But the rule is quite complex. Given that community banks are not likely to participate in such activities, there doesn't appear to be much to gain from having them maintain a compliance program. So I support exempting community banks from the Volcker rule.

Other simplifications are already taking place. Earlier this year, the federal banking agencies completed their decennial review of banking regulations to identify provisions that are outdated or unnecessary.[10] As a result of the review, 78 guidance letters were deemed out-of-date and were eliminated, and the data-reporting requirements for small community banks were reduced and simplified, resulting in a shorter Call Report.

In addition, exam frequency has been reduced for a large set of institutions. Now, 83 percent of all insured depository institutions qualify to be examined every 18 months rather than every 12 months, as a result of a provision in the Fixing America's Surface Transportation (FAST) Act that raised the asset threshold from $500 million to $1 billion.

---

[10] This review is required by the Economic Growth and Regulatory Paperwork Reduction Act. See the Federal Financial Institutions Examination Council's Joint Report to Congress on Economic Growth and Regulatory Paperwork Reduction Act, March 2017 for additional details (https://www.ffiec.gov/pdf/2017_FFIEC_EGRPRA_Joint-Report_to_Congress.pdf).

The agencies are also working to develop a simplified capital framework for community bank organizations.[11] For large banks, the combination of risk-based capital requirements, a leverage ratio requirement as a back stop, liquidity requirements, and annual stress testing is appropriate. But one has to ask whether the compliance costs faced by small community banks in adhering to a complicated risk-based capital regime outweigh the benefits in terms of safety, soundness, and financial system resiliency, compared to an alternative regime comprising a leverage ratio requirement based on high-quality capital, combined perhaps with a simplified risk-weighted capital requirement.

The guiding principle of aligning the degree of prudential oversight with risk applies not only to community banks but also to larger banks. Dodd-Frank requires that banks with assets between $10 billion and $50 billion be subject to company-run stress tests and that banks with assets of $50 billion or more be subject to annual supervisor-administered stress tests, capital planning, living will, and other enhanced prudential requirements. I support some increase in the thresholds but also believe that the combination of these requirements at systemically important banks has led to a stronger and more resilient financial system and should be maintained.[12]

Some of the amendments I've mentioned would require legislation; others would require coordinated action across the bank regulatory agencies. But the Fed is also working to improve its own supervisory processes to make them better aligned with risk and more efficient so that speedier decisions can be made. Since 2014, the Fed has used a risk-focused consumer compliance examination framework for community

---

[11] See a summary of some of the steps being considered in the Federal Financial Institutions Examination Council's Joint Report to Congress on Economic Growth and Regulatory Paperwork Reduction Act, March 2017 (https://www.ffiec.gov/pdf/2017_FFIEC_EGRPRA_Joint-Report_to_Congress.pdf).

[12] The Fed has already exempted nonsystemic banks with less than $250 billion in assets and less than $75 billion in nonbank activities from the qualitative, capital planning part of the stress-testing process. See "Federal Reserve Board Announces Finalized Stress Testing Rules Removing Noncomplex Firms from Qualitative Aspect of CCAR Effective for 2017," Board of Governors of the Federal Reserve System press release, January 30, 2017 (https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170130a.htm).

banks that helps examiners focus their attention on more serious compliance issues.[13] While this has been helpful, I have heard from several community bankers that it is still taking too long to close compliance examination findings. In looking at the timelines, even though some of the cases are complex, I have to agree that we can and should do a better job of reaching decisions in a reasonable period of time. Clarifying supervisors' expectations with respect to consumer compliance and community development rules would also be a good step.

The Fed is also undertaking a comprehensive review of its safety and soundness examination framework for community banks, and developing analytical tools so that we can better focus our supervisory efforts on the highest risks while reducing the regulatory burden on low-risk community banks.

I hope this brief review illustrates that the Federal Reserve is committed to following the guiding principle of aligning regulatory and supervisory oversight with the level of potential risk. This will allow us to reduce undue regulatory burden without compromising the health and resiliency of the financial system, an approach that will benefit banks of all sizes and the overall economy.

Conclusion

The financial crisis and ensuing Great Recession took a toll on all of us. Now, the economy and financial system have returned to health, and the goal is to keep both of them there. Monetary policymakers need to set policy appropriately to ensure that the expansion continues and our policy goals of maximum

[13] Jeffrey Drum, "Risk-Focused Consumer Compliance Supervision Program for Community Banks," *Consumer Compliance Outlook*, Second Quarter 2014 (https://consumercomplianceoutlook.org/2014/second-quarter/risk-focused-consumer-compliance-supervision-program-for-community-banks/), and "Community Bank Risk-Focused Consumer Compliance Supervision Program," *June 2014 Update to the Consumer Compliance Handbook*, Federal Reserve Board of Governors Division of Consumer and Community Affairs (https://www.federalreserve.gov/boarddocs/SupManual/cch/announce/201406cch_update.htm).

employment and 2 percent inflation are met and sustained. In my view, that means continuing on the path of gradually normalizing interest rates and the balance sheet. With respect to financial regulation and supervision, it means ensuring that the financial system remains resilient, with an appropriate focus on limiting systemic risk and the costs such risks impose on the economy when they are realized, helping to ensure that banks remain sound and able to extend financial services to their communities through the ups and downs of the business cycle, and avoiding regulations that impose burdens but do not further these goals. Getting the right balance entails a tiered approach to banking supervision and regulation. This tiered approach recognizes that the risk a banking organization poses to the financial system is likely to vary according to its size, range of activities, and complexity, and so supervision and regulation should vary along these dimensions as well. The rules and oversight that apply to community banks should not be the same as those that apply to systemically important institutions.

The Federal Reserve has been taking steps to right-size its oversight of banking institutions consistent with the risks they pose to the financial system because a sound financial system conveys benefits on households and businesses. Bankers have also taken important steps to better monitor their risks so that they can better deliver services to their customers.

At the end of the day, the public will be the judge of whether we have successfully met the challenges. According to the Financial Trust Index, published by the business schools at the University of Chicago and Northwestern University, there is still a ways to go.[14] While there has been some improvement since 2008, still only about 27 percent of those polled for the index said they trusted their financial institutions, broadly defined to include banks, the stock market, mutual funds, and large corporations. Lest I leave you on that disappointing note, I want to mention that the survey results differ significantly by type of

[14] The Financial Trust Index is based on an annual survey of a representative sample of about 1,000 American households. For further information, see the website: http://www.financialtrustindex.org/index.htm.

institution. Nearly 60 percent of the people polled said they trusted their *local* bank.[15] This is an encouraging sign that by focusing on safety, soundness, resiliency, and customer service, we can create a financial system that the public views as beneficial, and one that truly is.

[15] The 2015 results by bank category are available on the Financial Trust Index website at http://www.financialtrustindex.org/resultswave24.htm. I thank Professor Luigi Zingales at the University of Chicago for providing the updated results for 2016. In the 2016 survey, while 38 percent of respondents reported trusting their banks, 57 percent indicated that they trust their local bank.