Remarks on Banking Policy and the Economic Outlook

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Good afternoon. It is a pleasure to speak with you today. This conference on the future of banking has brought together leaders from across the U.S. banking sector. I have enjoyed the sessions so far, including Brandon and Tara's discussion earlier, and I look forward to learning more about how you are navigating change.

As some of you know, I've spent my entire career in and around the banking industry. My first job out of college was as an FDIC examiner right here in Kansas City. Before long, though, I transitioned from the public to the private sector.

For most of my professional life, I was a Nebraska banker. I served as president and CEO of a local community bank and a large enterprise with a national footprint. So, I have sat in the same seat as many of you. Later on, I was privileged to lead the Southwestern Graduate School of Banking Foundation at Southern Methodist University's Cox School of Business. The focus of the school was to develop bank leaders and educate community bank directors. My experience across the industry ultimately lead to my appointment in 2023 as president and CEO of the Federal Reserve Bank of Kansas City—a true servant leader opportunity.

So, throughout my career, I have worked in the banking sector as a regulator, as a banker, as an academic, and now as a policymaker. I really have seen banking from all sides, which I believe serves as a valuable foundation for my work today within the Federal Reserve System and, in particular, at the Kansas City Fed.

The Federal Reserve

My time as a Tenth District community banker gave me a strong appreciation of the Federal Reserve's unique regional structure. That appreciation has only grown in my current position.

A cornerstone of the System's design, which involves 12 regional Federal Reserve Banks and a Board of Governors in Washington, is that it ensures the entire country is represented in discussions around monetary policy. A little background on the history of the Federal Reserve is helpful to understand where the System is today. The Federal Reserve System was created more than a century ago, in part because people in middle America demanded it. Before the Fed's creation, community bankers in the Midwest had to rely on large money center banks in New York City and Chicago. A common complaint was that the supply of liquidity these banks provided was inelastic; that is to say it was not flexible enough to accommodate changes in credit demand.

Moreover, the pre-Fed banking system exposed credit-dependent households, farmers, and other business owners to the regular bank runs and financial crises that plagued the final decades of the 19th and the early 20th centuries. Financial instability in New York would spill over to the whole country. By providing flexibility in the supply of liquidity, the Fed met the economy's demands for currency and credit, while providing more stability in interest rates and less financial volatility (though, not without some significant exceptions).

Considering the Kansas City Fed specifically, the economy of our region is fundamentally distinct from other areas of the country. These differences underpin the Fed's design of 12 geographically defined regional Reserve Banks. The system was built around the idea that our nation is best served by a central bank that is directly engaged in communities across the United States, rather than one that is isolated in New York City or Washington, D.C. The system allows for policy decisions to be informed by conditions across the immense variety of industries and geographies that make up the American economy. It distributes decision-making power rather than concentrating it in Washington.

And this connection continues to be a vital part of what the Fed does. Events like this one today play an important role in that decision-making process. The Kansas City Fed serves the Tenth Federal Reserve District, a seven-state region that roughly 20 million Americans call home. As president of the Kansas City Fed, I represent the people of this district on the Federal Open Market Committee, which sets monetary policy for the United States. In making my decisions on the FOMC, I depend on district bankers like you to give me "boots on the ground" information about the challenges you face and the opportunities you see to shape my perspective on the regional economy.

Now, so far, I have mentioned setting monetary policy and promoting financial stability, both of which are essential parts of what the Fed does. However, it has several other key functions. As you all know, the Federal Reserve also promotes the safety and soundness of financial institutions through regulation and supervision. I'd like to spend most of my time discussing some principles that guide my thinking about bank regulation and supervision, before turning to a brief discussion of the outlook for the economy and policy at the end of my remarks.

Perspectives on Banking Policy

Banking, especially community banking, has long been important to the Federal Reserve Bank of Kansas City, as this conference demonstrates. Today we are honored to host leaders from many of the nearly 700 community banks that call Kansas City's Tenth District home. And as president of the Kansas City Fed, I know just how vital your banks are to our local economies. As I travel around the district, I have the pleasure of speaking with many business leaders from across the region. From those conversations, it's clear how critical community banks are in providing credit and other financial services to so many of the region's small and family-owned businesses.

The Federal Reserve System is, and has historically been, attentive to the health of community banks. The Kansas City Fed in particular has been vocal about community banks' unique role in the economy, as well as the competitive challenges they face. This focus has produced some important results.

For instance, in 2023 the Federal Reserve launched FedNow to support instant, 24-7 payment services for depository institutions of all sizes. To date, over 1,000 banks—most of them community banks—are already participating in this program. Why has this program been successful among smaller banks? Because at its core, FedNow is a secure platform that enables banks to build new, innovative products that provide households and businesses faster, easier, and lower-cost access to financial services. In other words, FedNow is an investment by the Federal Reserve to encourage innovation that might otherwise be too costly for small banks to create individually.

While progress has been made, it can sometimes feel that the deck is stacked against community banks. I believe there is still work to do. As a federal banking agency, the Federal Reserve has both supervision and rulemaking authority for state member banks, as well as certain other types of financial institutions. In fulfilling that responsibility, the Fed seeks to monitor and manage risks within the financial system without unduly limiting growth and efficiency within the banking system. While supervision and growth may sometimes seem to be at odds, I believe that confidence in the banking system and financial stability are essential to achieving long-term and sustainable economic growth.

With that being said, supervisors and regulators should take care to ensure that regulations and supervisory practices do not disproportionately or unfairly burden community banks in ways that unnecessarily stifle economic growth, innovation, or access to financial services.

In seeking to achieve this goal, it is also important that regulators recognize the significant differences in the business model, operations, and financial risks posed by banks of different sizes. While large institutions can benefit from greater geographic diversification and economies of scale, they also pose unique risks to the larger financial system related to their complexity, size, and inter-connectedness. On the other hand, while community banks may not achieve the same scale benefits as their larger counterparts, they often operate with less-complex funding structures and balance sheets. As such, the behavior of depositors and borrowers can be quite different and, thus, the risks quite different for banks of varying sizes. Supervisory practices and rulemaking should properly reflect these differences in striking the right balance between risk management and growth.

Striking the right balance has been a perennial concern of bank regulators for many decades. Over that time, my 40-plus years in the banking sector has shown me again and again that while there may be substantial social and technological changes, many of the core principles of sound financial risk management have remained the same. Therefore, I believe it is important that banking supervision focuses on core financial risks.

In some ways, the stress on several regional banks in early 2023 may have looked like something new, because it involved elements of social media and the technology sector, but mostly it was a textbook case of weak risk management. The Federal Reserve Board of

Governors' review of one failure agreed: Its report concluded that banks' "senior leadership failed to manage basic interest rate and liquidity risk."

Silicon Valley Bank (SVB), for example, had taken large, unhedged positions which went underwater once interest rates increased. Moreover, 94 percent of SVB's deposits were uninsured. To state the obvious, a bank funded overwhelmingly with uninsured deposits is an inherently risky business model. This is as true today as it was almost a century ago when federal deposit insurance was created. To me, the failures of 2023 only reinforce the need for supervisors to redouble their focus on core financial risks, including credit, interest rate, and funding risks.

Of course, even solvent, well-managed banks may need access to other sources of liquidity from time to time. Such banks can obtain funding from other financial institutions using the federal funds market or from the Fed's discount window. However, community banks often have more limited access to market-based funding sources, especially in crisis situations. Regulators should focus on widening the availability of funding and liquidity to smaller institutions. SVB's heavy reliance on uninsured, unstable deposits—and the rapid flight of those deposits that ultimately led to the bank's failure—shows the importance of banks maintaining diverse sources of funding, well-developed contingency funding plans, and operational access to emergency funding.

Since the Federal Reserve's adoption of the ample-reserves framework in 2019, domestic banks less frequently transact with each other in the federal funds market to fulfill their liquidity needs. Instead, they tend to borrow from the Federal Home Loan Banks in anticipation of liquidity needs, and in certain circumstances from the Federal Reserve through the discount window. Because large volumes of pledgeable collateral are not often readily available at smaller banks, this may put them at a disadvantage.

For this reason, the Federal Reserve has sought to modernize its discount window operations with Discount Window Direct, an online self-service portal that allows users to conduct Federal Reserve Bank Discount Window activities. And while real progress has been made in this respect, I believe there is more work that could be done to understand how the liquidity needs of smaller banks can be better served. The Federal Reserve should continue modernizing its discount window operations and working with banks and the Federal Home Loan Banking System to ensure funding is available quickly, where consistent with regulations.

Finally, regulators should let the market work. What do I mean by this? A healthy U.S. economy demands a dynamic banking system. To reach this goal, I see two necessary pieces that are intertwined: *de novo* chartering and mergers and acquisitions.

Mergers and acquisitions are an integral part of market functioning and development because they allow firms to achieve new efficiencies. However, M&A activity in isolation leads to a more consolidated banking system and a potential loss of access to critical financial services, especially in rural areas such as those across our region. For that reason, streamlining the approval process of *de novo* applications is also essential. As existing banks grow, merge, or are acquired, new banks must be able to fill voids in the market and push the industry in new, innovative directions.

Starting any new firm is no easy task. It requires substantial fixed costs and is an inherently risky endeavor. Starting a new bank has all of these challenges and more. Bank charter applicants must raise a significant amount of capital, seek out a set of specialized, high-skill professionals to manage operations, and must perform significant due diligence in developing a business plan and setting up a risk management framework. Though starting a bank is challenging under even the best circumstance, the fact that the number of new charters and charter applications are so low suggests to me that the approval framework may be getting in the way of a healthier banking industry. A holistic policy approach, including streamlining *de novo* applications and M&A reviews, are key to maintaining a dynamic banking system that will support strong US economic growth.

To summarize: Community banks face challenges – challenges I fully appreciate and have faced myself. But community banks also serve a unique and crucial role in local economies across the United States. While safety and soundness are always at the forefront of our minds, I believe that regulators and supervisors must continue to keep community banks' critical role in perspective and ensure that community banks have the opportunity to succeed.

The Outlook

I would like to wrap up with a few remarks on the outlook for the economy and policy. When setting the stance of monetary policy, the FOMC is guided by its congressionally directed dual mandate of price stability and full employment. The available data show that the Fed is as close to meeting its mandate as it has been for quite some time. In April, inflation was 2.1 percent, a level I view as being in line with the Fed's 2 percent inflation objective. We will receive labor market data for May tomorrow, but the April data had the unemployment rate at 4.2 percent, very close to many estimates of full employment.

However, lags in the effects of monetary policy suggest that the Fed should consider not only where the economy is when setting interest rates but also where the economy is going. And the outlook for the economy is currently very unclear, with many measures of economic uncertainty near historical levels. Speaking to business leaders and contacts in the Kansas City Fed's district, much of this uncertainty appears to be related to the trajectory and potential impact of changes in tariff policy. From my conversations, there is a general view that higher effective tariffs will lead to higher prices and lower activity and employment, but less conviction over the magnitude and timing of these effects. However, on balance there is a view that the two sides of the Fed's mandate—inflation and employment—are likely to come into conflict and require careful balancing.

I am optimistic that economic activity can be sustained in part as the considerable momentum we have witnessed in recent years continues to push the economy forward. The economy has shown tremendous resilience during the recovery from the pandemic and has repeatedly brushed aside recession fears. This strength reflects in part a healthy labor market and the beneficial dynamic of more jobs, leading to higher incomes and more spending, which in turn supports more jobs. Because of the centrality of the labor market to the health of the overall economy, tomorrow morning's May employment data release will attract attention.

As we saw during the pandemic, when strong demand growth runs into supply chain disruptions, perhaps as a result of tariffs, prices can increase rapidly. Though the recent inflation data has been subdued, the expectation is that tariffs will start to show through to prices in the coming months.

While theory might suggest that monetary policy should look through a one-time increase in prices, I would be uncomfortable staking the Fed's reputation and credibility on theory. So far, most measures of long-term inflation expectations remain anchored. However, this is not a signal that we should let our guard down. Inflation expectations should not be viewed as an input into Fed decision making, but rather as an output of the decisions that the Fed makes. Anchored expectations reflect the Fed's credibility and the public's trust in the Fed's willingness to make hard decisions when it has to.

Looking ahead, policy will need to remain nimble as the FOMC balances the two sides of its mandate. While the tariffs are likely to push up prices, the extent of the increase is not certain, and likely will not be fully apparent for some time. Likewise, the extent of the drag on growth and employment is also unclear. As the FOMC balances its mandate, I intend to remain focused on the importance of maintaining credibility on inflation.