

Guideposts for Supervision and Regulation as a Central Banker

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The views expressed by the author are his own and do not necessarily reflect those of the Federal Reserve System, its governors or representatives.

Thank you for the invitation to join you this morning. I appreciate the opportunity to speak with you, and I look forward to our discussion. I will spend most of my time speaking about the Fed's role as a supervisor and regulator of the nation's banking system, but with the recent Federal Open Market Committee meeting attracting much attention, I will first offer a few words on last week's monetary policy decision and my thoughts on the outlook for policy going forward.

Monetary Policy and the Outlook

As I am sure you are all aware, the FOMC lowered its target policy rate by 25 basis points last week. I supported this decision. Let me explain my thinking. In setting policy, I, like other members of the FOMC, am guided by the Fed's congressionally determined dual mandate of price stability and full employment. Currently, we are close to meeting this mandate, and as close as we have been for some time. Inflation is running around 2½ percent, which is above but near the Fed's 2 percent definition of price stability. Looking through the effects of declining energy prices, inflation has been closer to 3 percent. The unemployment rate in August was 4.3 percent, in the neighborhood of many estimates of full employment. But setting policy appropriately is not just about where the economy **is**, but also, given lags in the effect of policy, about where the economy **might be going**.

Through most of this year I have been comfortable holding the policy rate steady. I viewed this stance of policy as being modestly restrictive, which I believed was appropriate given the continued stickiness of inflation above our 2 percent objective. While many indicators suggest that the labor market has cooled this year, I viewed this cooling as consistent with relieving price pressure and returning inflation to 2 percent. However, some recent data suggests

a growing risk that the labor market may weaken more substantially or abruptly than I had been anticipating. As such, I viewed the 25-basis point cut in the policy rate last week as a reasonable risk-management strategy as the Fed balances its inflation objective with some heightened concern over the health of the labor market.

That said, my view is that inflation remains too high while the labor market, though cooling, still remains largely in balance. I view the current stance of policy as only slightly restrictive, which I think is the right place to be. Against this backdrop, I will continue to take a data-dependent approach to any further adjustments in the policy rate. I will be watching the incoming inflation and labor market data closely as I continue to assess the balance of risks to the Fed's dual mandate.

Just a final word on the policy path. One way to view the Fed's mandate is a responsibility to manage the trade-offs that arise from the economy-wide constraint that ties inflation to unemployment. Policies that boost the labor market often come at the expense of higher inflation, while policies that lower inflation often come at the cost of higher unemployment. Constraints lead to difficult decisions over how to balance competing objectives, and the Fed has been tasked with these difficult decisions when it comes to inflation and unemployment. I intend to take a data-driven approach to managing these difficult decisions going forward.

Supervision and Regulation

I would now like to turn my attention to the importance of the Federal Reserve's role in supervision and regulation. I began my career as a field examiner for the FDIC in the 1980s. This experience, which was during an especially difficult time for the banking industry, formed the

foundation for my views on the importance of managing risk within an organization. It also gave me a great appreciation for the role that banking regulators and supervisors have in ensuring the public is confident that their banks are safe and sound.

A few months into my tenure as president of the Federal Reserve Bank of Kansas City, I publicly shared what I termed “Guideposts for a New Central Banker.”¹ Those guideposts called for a degree of caution when considering the Fed's role in the financial system. They also outlined the value of the Federal Reserve’s regional structure, and the importance of the Fed's independence. Today, I'd like to discuss what might be called “Guideposts for Supervision and Regulation as a Central Banker.” You'll notice that many of the same principles apply.

First, I believe the Fed's role in banking supervision is a necessary responsibility for any central bank that seeks to effectively serve the public. Congress has tasked the Fed with protecting the health of the financial system, and in turn the economic health of the nation. That role is best supported by an independent, regionally structured organization with responsibility for financial system liquidity, monetary policy, the operation of the U.S. payments system, and the supervision of banking organizations that depend on that system. There has been much discussion historically, often politically charged, pushing against the Fed's role in supervision and suggesting the public would be better served by narrowing the Fed's mission areas and limiting its role in supervision. I think this view is misguided and could lead to unintended consequences that are often not sufficiently considered.

We often discuss how crucial the Fed's insulation from political interests and its regional structure are to effective monetary policy. However, the Federal Reserve System’s independence and the regional Reserve Banks’ close connections to local economies are just as central to sound

¹ Schmid, Jeff. “[Guideposts for a New Central Banker](#),” remarks delivered to the Economic Club of Oklahoma City. Feb. 26, 2024.

supervision and regulation. The separation of supervisory and regulatory authorities from direct political considerations allows supervisory actions in the long-term interest of financial stability and consumer confidence. Political independence in supervision allows for agility and quick responses to instability, fosters public trust in the banking system, and facilitates regulatory approaches that are impartial and consistent with prudential considerations.

Ultimately, bank regulation is accountable to the people of the United States. Congress passes and the president signs the laws that we, as regulators and supervisors, are tasked to implement. Supervision and regulation should be conducted objectively and consistently in the interest of financial stability and consumer protection, as prescribed by law.

The Fed's regional and branch structure enhances the effectiveness of supervision because it encourages the development of strong relationships between supervisors and local communities, each with their own economic characteristics. These connections, in turn, help examiners build localized expertise. This produces better-informed supervisory decisions that reflect each market's unique economic strengths and vulnerabilities. I believe that in many ways, the long-term supply of credit to small businesses and other industries served by mid-sized and smaller banking organizations depends on supervision being well-equipped with just such a regional perspective.

Lastly, I believe the Federal Reserve's supervisory function directly and significantly impacts our other mission areas. To enhance financial system stability, the Fed must thoroughly understand the banking system's liquidity needs, the health of individual banks, and their unique vulnerabilities to market disruptions, along with other factors that influence banks' resilience to financial stress. Without this comprehensive knowledge, there is a risk of implementing policy that fails to align with the realities of the financial system and broader economy. The very

establishment of the Federal Reserve was driven by the understanding that monetary and banking disruptions are interconnected. Moreover, the Fed bears significant responsibility for the seamless operation of the payments system—a vital yet often overlooked component of our economy. To uphold the integrity of the payments system, the Fed must be acutely aware of the current conditions of the institutions that access it. Having deep supervisory expertise allows the Fed to more accurately evaluate potential threats to the payments system.

There is an important interconnectedness here: Each of our mission areas—supervision, monetary policy, liquidity provisioning, and the robustness of the payments system—depends on the others to function effectively and cohesively.

The second regulatory guidepost I'd like to focus on today is the need for a properly tailored regulatory framework and supervisory approach that allows for a level playing field across institutions of all sizes. Given extensive regulation aimed at ensuring safety and soundness, it is certainly challenging for regulators to limit burden and foster competition, while maintaining banking system safety and soundness. Our nation's banks range from small traditional institutions to global systemically important banks. It is essential that our regulatory framework take these fundamental differences into account. To better serve the range of business models represented by these institutions, we must continue to look for ways to refine the supervisory framework.

Specifically, one area that requires further investigation is our approach to categorizing banks with static asset thresholds. These have likely become outdated given that they have not been calibrated to consider inflation or a rapidly changing industry with a wide range of business models. Earlier this year, Federal Reserve Vice Chair of Supervision Michelle Bowman shared a similar sentiment, commenting that banks sometimes unintentionally cross the \$10 billion

threshold, subjecting them to additional regulatory and supervisory requirements. In addition, she noted that banks approaching the \$10 billion threshold often choose to curtail their asset growth to stay below it.² While simple static asset thresholds allow for an objective definition that is easily observable and unambiguous, I believe the type of cliff effects described by Vice Chair Bowman are distortionary and make it worth our effort to consider whether there are better alternatives.

These static thresholds also naturally result in more banks being pulled into stricter regimes as industry balance sheets grow. For example, the \$10 billion threshold was established 15 years ago and has yet to be updated. It is clear that a traditional bank with just over \$10 billion in assets should not be treated the same as a complex firm approaching \$100 billion.

There are a few alternatives to our current approach that I believe are worth considering. One simpler and less subjective approach could be regularly updating the definitions of community and regional banks using indexed thresholds. This is potentially the simplest adjustment to today's framework. Another option I favor is incorporating a complexity adjustment into an index-based asset tiering system. Although this might be more challenging to implement, I believe it offers the most potential for a sufficiently tailored regulatory framework.

By considering both inflation-adjusted asset tiers and the complexity of a bank's business model, we could work toward a balance of simplicity and risk sensitivity. I believe this approach would be most likely to reduce distortions and improve tailoring precision, addressing the concerns I previously outlined. While more precise, these options do present their own unique challenges: Particularly, these approaches might introduce complexity, leading to subjective

²["Community Banking,"](#) remarks by Michelle Bowman at the Robbins Banking Institute Lecture Series. Feb. 27, 2025.

interpretations, higher costs, and implementation difficulties. Nonetheless, I think these alternatives offer advantages and are worth considering.

The last of my regulatory guideposts as a central banker is that we should have a strong focus on transparency across our supervisory and regulatory frameworks while protecting overall safety and soundness. By prioritizing transparency, regulators can improve industry understanding and implementation and enhance the effectiveness of oversight without compromising the fundamental goals of safety, soundness and integrity.

One opportunity to improve transparency while also enhancing regulatory effectiveness is to redouble our focus on material financial risks. To be sure, supervisors are warranted in providing some level of oversight of non-financial risks; however, recalibration may be necessary. In other words, proper governance of a financial institution is of vital importance, but an overweighting of more process-driven non-financial risks in supervisory conclusions can dilute the attention given to core financial risks that drive the overall health of an organization.

Another opportunity for enhancement lies in the continued simplification and tailoring adjustments to capital requirements, which are fundamental to the stability of the financial system. The existing capital framework must adeptly capture the varying degrees of risk exposure and preclude any unfair advantages among banks of differing sizes and complexities. Should there be consideration to lowering the capital requirements for the most systemically important banks, it is crucial to thoroughly consider the associated costs and to avoid creating any real or perceived market advantages that could diminish competition and spur further consolidation.

For example, the introduction of the community bank leverage ratio framework in 2020 marked a positive step toward capital-related burden relief for smaller, less-complex institutions.

However, as of the end of June, despite 83 percent of community banks being eligible, only 40 percent have opted into the reduced reporting requirements. While the benefits to these 40 percent are certainly noteworthy, the question arises as to why less than half of the eligible banks are participating. This discrepancy suggests a need to reassess the relief provided and whether the thresholds, including asset thresholds, should be broadened or simplified.

This is just one example highlighting the need to continue evaluating whether our capital framework is appropriately calibrated for small and mid-sized banks, particularly if capital constraints are reduced for the largest institutions. Ensuring a level playing field in terms of the cost of capital and the complexity of the capital framework is vital for maintaining a competitive industry that effectively serves local communities and small businesses.

Conclusion

I want to thank you again for the opportunity to join you today. The future of banking remains incredibly promising, and I am particularly optimistic about the vital role that small and mid-sized banks will play. Your unique business models and ability to serve the needs of large business customers in your markets foster the country's economic growth and highlight the importance of the diversity in our banking system. I look forward to the rest of our discussion today.