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Testimony by

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before the

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of the

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I am pleased to be here to discuss regulatory burden and particularly the study of this subject which the Federal Financial Institutions Examination Council (FFIEC) conducted last year in response to Section 221 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Some of you may recall that I testified before this subcommittee on behalf of the Federal Reserve on the topic of regulatory burden last June, while the FFIEC study was in progress.

The issue of the appropriate level of regulation of banking institutions is not new. Banking institutions serve a vital role in the U.S. economy because of the critical functions they perform: in the payments mechanism, as chartered recipients of federally insured deposits, as credit intermediaries, and as the principal vehicle through which monetary policy is implemented. The strength of the U.S. economy depends on a healthy banking system to support its operations and growth.

It is because of the important role that banking institutions play in the economy that they are regulated. Safety and soundness regulations were introduced in the last century to minimize the destabilizing effects on the economy of difficulties in the banking system. The introduction of federal deposit insurance in the 1930's further increased the government's need to protect its interests. More recently, because of their importance in providing financial services to consumers and others, banks have been viewed as vehicles for implementing social policies including consumer protection and law enforcement.

Whatever their purpose, the ever increasing number and detail of regulatory requirements and restrictions has increased the costs and reduced the availability of services from banking institutions. An excess of requirements and restrictions imposes a heavy burden on institutions and has reached the point where the aggregate burden may frustrate the purposes of the individual regulations by driving traditional banking functions into alternative providers of these services that may not be subject to the same requirements and restrictions.

Section 221 Study on Regulatory Burden

In enacting Section 221 of FDICIA, Congress recognized the growing significance of this burden. Section 221 required the FFIEC to review the regulatory policies and procedures of the banking agencies and the Treasury Department to determine whether they impose "unnecessary" burden on banking institutions, and to identify any revisions that might reduce burden without endangering safety and soundness or diminishing compliance with or enforcement of consumer laws. The FFIEC was directed to report its findings by December 19, 1992.

During early 1992, the four federal banking agencies and the Department of the Treasury undertook extensive internal reviews of their policies, procedures, recordkeeping and documentation requirements. In addition, an interagency task force assembled and reviewed the public comments that the Federal Deposit Insurance Corporation (FDIC), the Office of the

Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) had received in response to their Spring 1992 requests for comments on regulatory burden. The FFIEC also requested and received public comments on ways that burden might be reduced and held public hearings on this topic in Kansas City, San Francisco, and Washington, D.C.

At the outset the FFIEC stated its belief that the goal of this process was not to examine and develop proposed revisions to the overall statutory scheme governing financial institutions. Rather, it appeared to the Council that the Congressional intent was to accept the statutory scheme as a given and instead to examine the manner in which the federal banking agencies and the Treasury Department have implemented that scheme by means of regulations, policy statements, procedures and recordkeeping requirements.

Many commenters, as well as the agencies themselves, recommended changes which were within the jurisdiction of the agencies. During the year, the agencies acted on many of these suggestions for regulatory improvement, particularly those related to required reports, examination procedures, and application processes. A summary of those actions is included in the study. Regulators have also increased their efforts to coordinate policies and procedures, which should lessen the burden on banking organizations.

Other specific recommendations from the public for regulatory change were reviewed by interagency working groups and

divided into three categories. The first category consists of approximately 60 recommendations that warrant further consideration as changes that may be effective in reducing regulatory burden. In most cases, the agencies agreed on the general approach to a recommendation and developed a consensus position which is described in the accompanying discussion. In a few cases, further consideration and possibly some compromise may be required to implement a change in current procedures, and in some cases a recommendation was controversial and an agency supported it only in part or preferred an alternative approach to meet the goal of the recommendation.

Some of the more notable recommendations include clarifying standards for loan and lease loss allowances, developing a uniform interagency policy regarding supervisory standards for assets sold with recourse, and instituting unified call reports so that all the banking agencies request the same information from regulated institutions. Consideration of each of these recommendations is currently underway in FFIEC subcommittees and task forces.

The agencies, after careful consideration, concluded that the other suggestions either did not meet fully the standards set forth in Section 221 or concerned non-Council member agencies. Separately, an analysis of the public recommendations concerning the rules implementing the Bank Secrecy Act (BSA) was contributed by the Department of the Treasury.

In addition to analysis of specific suggestions for change, the study addressed more generally the nature and cost of regulatory burden. Burden ultimately arises from two sources: 1) prohibitions that prevent regulated institutions from engaging in activities that they might otherwise undertake; and 2) requirements for certain specific actions or behavior patterns that regulated institutions would not undertake in the absence of the requirements. Restrictions on activities, such as limitations on interstate branching and on investment banking activities, fall into the first category, while paperwork and required compliance activities fall into the second. Both prohibitions and requirements can be costly to the regulated entity.

Furthermore, often it is not only the prohibitions and requirements themselves but changes in either that can impose costs. Cost studies, as well as public comments and testimony, indicate that the costs of adjusting to frequent (and sometimes minor) revisions to laws and regulations are a major component of regulatory burden. Therefore, slowing the pace of legislative and regulatory change, avoiding marginally necessary changes, and allowing reasonable transition times for implementation of revisions in legal requirements could reduce burden meaningfully.

The current approach to regulation, which often relies on mandates and uniform standards, has led to inflexibility that can be costly. Very specific requirements necessarily bring standardization, especially when detailed standards or methods of

compliance are set out in the law itself and no exceptions are allowed. Such inflexibility can be costly, though, since it tends to preclude new approaches, prevent innovation, and even to limit access to new technology and new markets.

Overall, the study concluded that the regulatory burden on the banking system is large and growing. Although the FFIEC did not undertake new cost studies of its own, available studies conducted by other researchers suggest that the costs attributable to banking regulation are substantial. Despite methodological and coverage differences, findings are reasonably consistent that regulatory costs might be in the range of 6 to 14 percent of noninterest expenses, without including any measurement of the opportunity cost of reserve requirements. Since noninterest expenses of the banking industry were $124.6 billion in 1991, if the percentage estimates are correct, regulatory costs to the industry in 1991 could have been between $7.5 and $17 billion, without any adjustment for the costs of reserve requirements or prohibited activities.

Additionally, cost studies of consumer regulations indicate that there appear to be economies of scale in compliance costs. In other words, the cost of regulation may fall heaviest on smaller banks. Descriptive statistics from the recently completed Independent Bankers Association of America (IBAA) study suggest that scale economies may exist for regulations other than consumer regulations.

Reducing Regulatory Burden

In the weeks since the study was submitted to Congress, the agencies have continued to consider the suggestions, and I anticipate that further action will be taken in the near term. The steps already taken by the regulatory agencies and the 60 specific suggestions for further consideration represent a beginning--an important first step. Nonetheless, the 60 suggestions are generally quite technical, and their overall impact on regulatory burden is likely to be modest. While many of the suggestions are good ideas and the agencies will give them further consideration, significant relief from regulatory burden will require more substantial changes.

Administrative relief, though, is limited by statutory requirements. In many cases, legislation is very detailed in its requirements, and the regulations must track the statutory provisions. Thus, the agencies have little power to change many provisions that impose substantial burdens. Legislative changes are required.

Although proposed statutory reforms to ease regulatory burden were not the intended or primary focus of last year's study, the Council recognized when it undertook this process that suggestions regarding appropriate legislative action to ease regulatory burden might well arise. During the course of the study, many valuable suggestions regarding potential statutory revisions were indeed forthcoming. Accordingly, the Council's member agencies have agreed to continue meeting to identify and

recommend possible statutory changes to reduce regulatory burden further. The Council hopes to prepare a separate report to Congress on those issues by late spring.

Recommendations for the Future

As I noted, banking institutions are regulated because of important public policy considerations. Much of the regulation arises ultimately from four fundamental public policy concerns: banking market structure and competition, banking safety and soundness, systemic stability, and consumer protection. The safety and stability of the banking system is vital to the economy. Further, it is difficult to quarrel with the purposes of individual consumer protections. Nevertheless, the aggregate effect of the implementation of a substantial number of desirable policies may result in burdening individual banking transactions to an unacceptable degree.

Many have noted, for example, the tremendous growth in the number of documents involved in a home mortgage loan. Similarly, making a small business loan, which is often secured by real estate, has become costly and can take up to 90 days, due in large part to real estate appraisal requirements. Often, the need to adopt regulations to implement many statutes may generate substantial detailed documentation that banks must read and interpret as the agencies respond to public comments and address concerns about potential bank liability.

In the aggregate, this burden has become substantial,

raising the costs of banking services and thus encouraging bank customers to seek less costly loans and services or higher-yielding investments from other financial intermediaries that are not subject to the same regulatory requirements and restrictions. The movement of business from banking institutions to other intermediaries and directly to money and capital markets may frustrate the purposes for which banking regulations were adopted. I believe this burden has already begun to threaten the competitiveness of the banking industry itself.

What is needed is fundamental review of approaches to regulation in search of mechanisms that will achieve the same goals but with less burden and without the problems which accompany the current approach. New approaches to regulation which are more sensitive to cost/benefit tradeoffs must be sought and considered. In particular, existing market forces and incentives should be harnessed as much as possible to achieve regulatory goals, rather than relying on micro-level regulations that eliminate the flexibility that is important in a dynamic industry.

To the greatest extent possible, banking regulation should provide flexibility by tailoring requirements to specific facts and circumstances and by distinguishing among institutions according to meaningful criteria such as condition, size, and management competence. Regulations that provide insufficient flexibility can cause unnecessary regulatory burden and create inefficiencies by preventing depository institutions from finding

the most cost-effective means of complying with the law or regulation and by impairing the ability of banking institutions to react to changing market conditions.

These approaches must be applied not only to future regulatory actions, but to existing regulations as well. Efforts to reduce regulatory burden substantially will undoubtedly raise difficult questions about the tradeoffs to be made between competing public policies, much like the on-going discussion of the federal budget. Because achieving political consensus for change may be difficult, in my judgement, an independent nonpolitical commission charged with exploring possibilities for legislative change would be useful. Such a commission could address a broad range of banking issues, such as regulatory burden and the competitive position of U.S. banking organizations, offer suggestions and guidance for legislative and regulatory changes, and assist Congress in developing a specific legislative agenda.

Summary and Conclusion

Banking institutions serve a vital role in the U.S. economy. The regulatory burden which we have imposed, however, may now threaten their role in providing the services which are so important to the health of our economy. We must be careful not to constrain our banking system so much that it is not responsive to the country's needs. In an increasingly global and competitive financial market, the U.S. can ill afford to handicap

its banking institutions--and therefore the individuals and businesses they serve--with stifling and constantly changing rules and regulations.

The regulatory burden on banking institutions is large and growing. The **cumulative** regulatory burden on the banking industry may well be more than the sum of its parts. This burden has grown slowly but relentlessly over the years, layer by layer by layer. While there may be genuine public policy benefits from any single regulatory proposal, it is important to recognize that the banking regulations and prohibitions, taken together, create a burden that is substantial, if not approaching unmanageable, for many institutions. When aggregated, these burdens affect the economy by reducing the efficiency and competitiveness of the banking industry.

At this time, we need to make fundamental decisions. If there is to be a real reduction in burden, we must revisit our overall approach for developing banking laws and establish a more direct process for balancing the benefits of regulatory proposals with the burdens they inevitably impose. We cannot continue to view banking institutions as the appropriate vehicle for implementing government policies without recognizing the costs. While the intended benefits of a regulation may be evident, it is important to recognize that those benefits are not free to society, or to consumers, because they appear to be paid for by the banking system. Those costs are shifted to consumers through lower interest rates paid on deposits and higher costs for loans

and other banking services.

Administrative relief, though, is limited by statutory requirements. In many instances, the agencies have little power to change the provisions that impose substantial burdens. Significant reductions in regulatory burden will require legislative action--and more than minor adjustments to the existing laws and regulations.

I hope that the FFIEC study completed last year represents the start of an ongoing process to address the problem of regulatory burden on the banking industry. The steps already taken by the regulatory agencies and the 60 specific suggestions still under consideration represent an important, if modest, first step. Perhaps regulatory relief, like regulatory burden, can be cumulative.