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Mr. Chairman, I am here this morning to discuss recent steps taken by the Federal Reserve, in cooperation with the other federal bank regulatory agencies, to reduce regulatory burden on financial institutions and facilitate an increased flow of credit. The regulatory burden on depository institutions has taken on new importance following enactment of the Financial Institution Reform, Recovery and Enforcement Act of 1989 (FIRREA), the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), and the evidence of restrained lending by banks. The costs to commercial banks and to other depository institutions of adhering to banking laws and regulations continue to grow and, despite the industry's recent record profits, could begin to threaten the industry's long-term competitiveness. I have testified several times on these and related matters in recent months and would hope that the increased attention given to these topics can lead to meaningful reductions in regulatory burden for the banking system.

With that said, but before discussing details of new initiatives, I would like to emphasize the limited ability of the regulatory agencies to encourage a pick-up in loan growth through administrative actions and also the risks inherent in attempting to reduce regulatory burden substantially simply by changing regulatory or supervisory policies and procedures. The results of lender surveys taken by the Federal Reserve have for several years consistently indicated that the slow or negative growth of

bank lending has been more a result of weak loan demand than of any other factor.

Changes in supervisory or examination practices may help at the margin, but they are unlikely to produce fundamental changes in credit conditions. There are many reasons why that is the case, mostly dealing with the recent recession and the need and desire on the part of both businesses and consumers to strengthen their balance sheets. It is also clear from the large number of bank failures during the past half-dozen years that credit standards needed to be improved at many banks. It is important, therefore, that any regulatory policy changes designed to spur additional bank lending not weaken the fundamental supervisory process. The recent actions we have taken have been carefully designed with that principle in mind.

Recent Policy Announcements

The federal bank regulatory agencies realized before passage of FDICIA that their supervisory actions may be imposing an undue burden on some banks and unnecessarily constraining the availability of bank credit. Consequently, in late 1991 the agencies issued joint statements clarifying their examination policies regarding commercial real estate loans and generally encouraging banks to work with troubled borrowers in resolving problem loans.

More recently, we have jointly taken numerous other efforts to reduce regulatory burdens, while still adhering to

relevant banking laws and fundamental principles of bank supervision. Several initiatives were announced on March 10th, and further details have been subsequently put forward, including a series of policy statements issued on June 10th.

March Policy Statement. The March statement sought to improve the availability of credit to small and medium-sized businesses and farms and covered other supervisory issues as well. Perhaps its most important element was the announcement of forthcoming changes to agency rules regarding the need for real estate appraisals by certified or licensed appraisers. Such appraisals, which relate to a requirement of Title XI of FIRREA, have been controversial and costly to banks and their customers. They will be required less often if the proposed rules are adopted.

The proposed change, issued for comment on June 10th, would (1) increase the threshold amount for which such appraisals are required from $100,000 to $250,000, (2) expand the "abundance of caution" exemption, so that an appraisal is not required when the value of the collateral is not material to the decision to make the loan and (3) exempt from appraisals business loans less than $1 million, where the principal source of repayment is not the sale of or income from the real estate held as collateral. These changes are designed to reduce burden imposed by the appraisal regulation, while still requiring appraisals when they are needed to enhance the safety and soundness of financial institutions.

Another important provision described a policy change that would permit strong and well-managed banks to set aside a limited portion of their loans to small- and medium-sized businesses. That selected portfolio of loans would then be evaluated by examiners only on the basis of its performance and not on the level of loan documentation.

This change was intended to foster an environment in which banks could extend more so-called "character" loans to businesses with which they were familiar and to base their lending decisions principally on professional judgments about the borrower's overall creditworthiness without being exposed to examiner criticisms about the specific nature or lack of documentation about the borrower. This change was consistent with an overall effort by the agencies to refocus supervisory attention to areas where risks are high and to reduce regulatory burden where risks are less, such as with strong, well-managed banks. It was also part of a broad effort to increase the availability of credit to low- and moderate-income neighborhoods and disadvantaged rural areas.

Final elements of the March statement committed the agencies to enhance their examination appeals procedures and to take other steps to improve the examination process, reduce regulatory uncertainty, review certain accounting policies and, in general, work to reduce regulatory burden. Some of these and other initiatives were expanded through a series of joint

statements issued earlier this month. Since they are more recent actions, I will discuss them in greater detail.

June Policy Statements. The series of June 10th policy statements dealt with a variety of issues, mostly intended to reduce impediments to the extension of credit and, in some cases, to conform supervisory and examination procedures to newly adopted accounting standards. The regulatory agencies also issued important new initiatives intended to detect and deter discriminatory lending practices. Finally, the agencies also reaffirmed earlier agreements to coordinate their examinations.

Much of the recent tightening of credit standards by banks and the subsequent reduction of bank credit to many borrowers can be traced to widespread problems in commercial real estate markets. In many cases, these problems resulted from weak underwriting standards that accommodated much over-building throughout the country and created serious financial difficulties and even failures at some banks. Even institutions that were not materially affected by problem real estate credits were prompted by events to review their own lending standards in light of new developments and economic conditions. Similarly concerned by these events, many examiners also began to look more closely and to review more critically the strength of commercial real estate loans, in particular, and entire loan portfolios, in general. All of these factors prompted a tightening of the terms of lending and a subsequent reduction in the availability of credit.

In large part, many of these changes represented a reasonable and appropriate response to recent events and to the reduced ability of some banking institutions to incur additional risks. To some extent, however, they reflected an over-reaction on the part of both bankers and bank examiners that has required the banking agencies to review their supervisory policies and to clarify them where necessary.

Real estate loans. Since real estate loans have contributed to many of the recent problems within the banking industry, several of our policy statements have focused on that topic--in particular to problems in accounting for and evaluating real estate collateral. These problems may be especially important to the financing of small- and medium-size businesses, which often rely heavily on real estate collateral to support bank loans.

One of the June 10th statements reaffirmed a November, 1991 statement that emphasized it was NOT regulatory policy to value real estate collateral that underlies real estate loans on a liquidation basis. Rather, the evaluation should be based on the borrower's willingness and ability to repay and on the income-producing capacity of the underlying collateral over time.

A decline in the collateral value below the book value of the loan does not require an automatic write-down or increased loss reserve if the loan is performing and the cash flow appears adequate to service the outstanding balance. The portion of the loan balance that is adequately secured by the value of the

collateral should generally be classified no worse than "substandard." Moreover, when an institution has taken a sufficient charge-off so that the remaining recorded balance of the loan is being serviced and its collection is reasonably assured, classification of that balance may not be appropriate.

The 1991 statement and the most recent reaffirmation are intended to ensure that commercial real estate credits are evaluated in a consistent, prudent, and balanced fashion. The Federal Reserve will continue to ensure that these policies are implemented in an appropriate manner.

Other June statements relating to real estate credits involve the accounting treatment of loans collateralized by real estate and, more generally, to the reporting of nonperforming loans. The collateralized loan issue relates to the matter of "in-substance" foreclosures and to the current accounting practice of transferring such loans to "Other Real Estate Owned" with recognition of appropriate losses. This practice, which had been required under Generally Accepted Accounting Practices (GAAP), has increased the volume of OREO balances at banks and may have discouraged lenders from working with borrowers that are encountering cash flow or other financial problems.

Recently, the Financial Accounting Standards Board has issued Statement No. 114, "Accounting by Creditors for Impairment of a Loan" and has clarified that creditors should report a loan as OREO only when they have taken possession of the collateral. The policy statement applied this recent FASB change in

accounting standards to the banking industry's regulatory reports. Although depository institutions must continue to recognize losses on real estate loans that meet the standards of in-substance foreclosure, the Federal Reserve believes that avoiding the designation of OREO--combined with other initiatives being taken--will reduce impediments to additional extensions of credit.

In a related area, the agencies have reached several agreements relating to "special mention" assets, which are assets demonstrating weaknesses, but that are not sufficiently weak as to warrant classification. We now have a common definition for special mention assets and will not assign loans to that status solely on the basis of documentation exceptions that are not material to the repayment of the asset. Moreover, the Federal Reserve will continue its long-standing practice of not including these assets in ratios used to measure asset quality.

Other accounting changes. The agencies have also revised the criteria required for banks to remove loans from nonaccrual status. Currently, banks must place loans for which payments are past due for 90 days or more on a nonaccrual status and must maintain that status until all overdue payments are received and full collectibility is assured. This requirement has sometimes overstated the severity of problem assets by failing to recognize losses banks had taken on the loans and subsequent improvements in the ability of borrowers to service the remaining balance. In turn, the continued labeling of such

loans as nonaccruing loans places pressure on banks to increase loan loss reserves or capital levels and may tend to discourage additional loan growth.

Effective immediately, banks may return nonaccruing loans to an accruing status under specified and less restrictive conditions than were previously required. Essentially, a bank may do so if a sufficient amount of a restructured loan has been charged-off and the borrower's prospects and recent payment experience indicate an ability to perform under the restructured agreement. Loans that have not been formally restructured and partially charged-off may also be restored to accrual status if required payments are being made and full repayment is expected under the originally contracted terms.

Coordinating examinations. The policy statement relating to the coordination of interagency examinations is intended principally to address costs to the industry of multiple or duplicative examinations. As required by law, various parts of a consolidated banking organization must be examined by different agencies--the Office of the Comptroller of the Currency in the case of national banks; the FDIC in the case of state nonmember banks, and the Federal Reserve in the case of state member banks, parent holding companies, and nonbank subsidiaries. Reflecting this supervisory structure, the banking agencies have had for many years supervisory procedures designed to avoid or at least to minimize overlapping efforts by relying on examinations

or inspections conducted by an entity's primary regulatory authority.

Nevertheless, industry trends have increased the real and perceived overlap in supervisory procedures. Banking organizations have become more complex and integrated in the conduct of their activities, often giving less consideration to the legal structure of their businesses. This pattern sometimes requires examiners of one entity to discuss or evaluate activities conducted elsewhere in the consolidated organization in order to understand and identify the risks. This situation increases the need for coordination among the banking agencies.

Looking forward, the requirement of FDICIA that the agencies conduct full scope, on-site examination of each depository institution every year may increase the perception of overlapping examinations and greater regulatory burden. Although annual examinations have been common for institutions supervised by the Federal Reserve, the legal requirement may increase the visibility and on-site presence of examiners at institutions supervised by other agencies.

In order to reduce or minimize regulatory burden on the banking system that can arise from multiple examinations, the agencies have clarified and reaffirmed the agreement that the examination or inspection of a bank or bank holding company will be conducted by the federal regulatory agency that has primary supervisory authority for that entity. Other agencies will rely on the reports of that agency and may, when necessary,

participate in the examination or inspection by the primary regulator. Although coordinated examinations may not be practical in all cases, particular emphasis for implementing this program will be placed on large or weak institutions. The program also covers other information-sharing arrangements with both federal and state banking supervisors.

On a separate but related issue, the Federal Reserve is reviewing the merits of conducting on a more coordinated basis the various "special purpose" examinations, such as those for trust activities and computerized systems (EDP). Whether examinations for consumer compliance could also be combined with those for safety and soundness raises other issues, involving both logistics and policy, particularly in the present environment of emphasizing the enforcement of laws prohibiting discriminatory lending.

Although these different examinations have been traditionally conducted independently in recognition of the specialized training needed to review the disparate activities, in some cases it may be possible to perform two or more of these reviews simultaneously and with less disruption to the institution. Indeed, we are currently conducting on an experimental basis an examination of a state-member bank in which several different examinations and the inspection of the parent bank holding company are being performed together. The initial reactions on the part of the bankers and the Reserve Bank staff to this approach have been positive.

Fair lending practices. A crucial element in the series of recent policy statements describes a number of initiatives related to fair lending practices. These initiatives were preceded in late May with a letter to the CEOs of all U.S. depository institutions, signed by the heads of all four federal bank and thrift regulatory agencies, that cited the importance of fair lending practices and stressed the commitment of the agencies to enforcing fair credit laws. The letter also urged special consideration to 11 specific fair lending activities, such as enhanced training, second review programs, and affirmative marketing and call programs.

Subsequently, on June 10th, the agencies announced development of a new training program in fair lending for experienced compliance examiners and the initiation of related programs for senior industry executives. These and other efforts should increase the awareness of lenders to the often subtle practices that disadvantage low-income and minority individuals.

The agencies are also exploring additional methods of detecting discriminatory practices and will improve their procedures for referring violations of the Equal Credit Opportunity Act to the Department of Justice. Each agency will also evaluate its consumer complaint system to determine what improvements should be made to its own procedures. In the meantime, the Federal Reserve has referred ten complaints alleging mortgage credit discrimination to the Department of

Housing and Urban Development under an interagency cooperation agreement signed last year.

In recent months the Federal Reserve has been testing a statistical model, similar to that used in a study by the Federal Reserve Bank of Boston, that is designed to assist examiners in analyzing the compliance of mortgage lenders with fair lending laws. This system does not, by itself, determine the presence of discrimination, but would serve as a tool to lead examiners more effectively to loan files that warrant closer review for comparative analysis in making that determination. The Federal Reserve has had educational programs in place for some time and will continue to build upon them. For example, last year the Federal Reserve Bank of Kansas City sponsored a conference for bankers on "Credit and the Economically Disadvantaged." In addition, the Federal Reserve Bank of Boston recently published a brochure for bankers on lending discrimination called "Closing the Gap" that should help them recognize and correct potentially discriminatory policies and practices. Such educational programs for both bankers and examiners have been and will continue to be an important part of the Federal Reserve's effort to promote and enforce fair lending practices.

Banking Laws and Regulations

Banking laws and regulations exist for reasons that are critical to the smooth functioning of our economic and social structure. We must, for example, minimize or prevent significant

disruptions to the nation's financial and payment systems; we must work to ensure that all citizens have fair access to credit; and we must also protect taxpayers, in general, from excessive costs of bank failures. Nevertheless, the Federal Reserve and the other banking agencies should continually review their policies and procedures to avoid placing unnecessary burdens on the banking system. As conditions change, the need for or effect of banking laws should also be reviewed.

In considering what steps to take, it is helpful to be guided by fundamental principles of supervision and regulation. Both the Congress and the regulatory agencies should have a clear understanding of why we supervise and regulate banks and what our goals are and should be. These goals should recognize the role of banks in our society and in financial markets. They should also recognize the high level of competition in these markets and the value of maintaining a strong, vibrant, and competitive banking system.

Our regulatory and supervisory goals should NOT be to prevent banks from taking risks or to have a system that is so restrictive that no bank ever fails. Risk-taking is essential for economic growth. Rather, the goals should focus on maintaining economic and financial stability, ensuring that businesses and consumers have adequate access to credit, and deterring excessive risk-taking that can arise because of the existence of deposit insurance and the overall structure of the federal safety net.

Banking laws and regulations should be compatible with social objectives, and they should also contribute to minimizing costs to the public when banks fail. They should not, however, be unnecessarily restrictive or suppress innovation and growth by attempting to micro-manage banking organizations. In view of this, it seems reasonable that new laws or regulations be subject to an appropriate cost/benefit analysis when they are considered.

The legislative and regulatory process should also recognize the role of supervisory actions, which can adapt to specific factors and conditions at individual institutions much better than can laws and regulations that are necessarily more formulaic and rigid. In this connection, banks that pose less risk to the safety net or that demonstrate superior performance in certain areas should be permitted greater flexibility or expanded powers than banks with less favorable performance records or that present greater risks.

The Federal Reserve has often advocated several elements of legislative change that I believe the Congress should consider. They relate to the payment by the Federal Reserve of interest on required reserves, the elimination of barriers to interstate branching, and the expansion of powers--especially regarding securities underwriting activities--for strong and well-managed banking organizations. Taking these steps would, I believe, improve the long-term outlook of the U.S. banking system by helping it to compete more effectively with many nonbank

institutions that are not similarly constrained in their activities or that do not incur these and other regulatory costs.

I would also hope that the principles I have outlined would be applied when considering the need for future legislative changes affecting banks. Some laws, including those designed to achieve desired social goals, have extracted high regulatory compliance costs on banks, often with questionable positive results.

Last year, for example, representatives of the Federal Reserve and the other federal banking agencies conducted a variety of "town meetings" throughout the country on the subject of regulatory burden. I participated in those meetings and believe that they provided useful insights into the regulatory process and into areas that should be reconsidered. Discussions often turned to the subject of consumer compliance laws, with bankers generally complaining about their high regulatory costs, and consumer advocates often stating that the requirements have not accomplished their intended goals. Unfortunately, when revisiting the relevant regulations, agency staff believed that most of our specific requirements are required in order to implement the laws.

As is often the case when making public policy, there are few clear and simple answers to important and complex problems. Further efforts to reduce regulatory burden will undoubtedly raise difficult questions about the trade-offs to be made between competing public policies. As you know, I suggested

to the Subcommittee in February that one way of dealing with these issues may be to establish a nonpartisan commission to explore possible legislative changes. Regardless of the approach the Congress takes, the Federal Reserve looks forward to working to find ways to improve the framework of banking laws and regulations.

Conclusion

In closing, I would mention that the Federal Reserve has an on-going program to review its regulations in order to monitor their effectiveness and related burdens. I would also assure the Subcommittee that the Federal Reserve is highly sensitive to the matter of regulatory burden and that we seek to avoid imposing unnecessary or ineffective requirements or constraints on the banking system. Nevertheless, the level of regulatory burden has increased as new banking legislation and implementing regulations are imposed. This continuing and only additive process is taking a significant and undesired toll that is easily measured by the declining share of U.S. financial assets held by banks.

Banking institutions perform a vital and unique role in our economy by providing credit to all segments of our society, by facilitating payments of goods and services, and by providing the mechanism for the conduct of monetary policy. If the banking system is to continue its role, it is incumbent on bankers to remember their long-term interests and to conduct their

activities responsibly. This means operating both prudently and fairly and being responsive to the credit needs of their communities. To do otherwise, banks risk the continued loss of market share and the prospects of still further rules and regulations.

Perhaps the most useful actions bank regulators and lawmakers can take is to avoid imposing additional competitive disadvantages on banks and to conduct their activities in a balanced fashion and with a broad perspective on the role of banks in our society. Beyond that, to the extent existing laws and regulations can be reduced, made more efficient, or applied more equitably to broader segments of the financial industry, we may accomplish not only greater fairness in lending, but also greater fairness in regulating.