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Regulatory Burden and Bank Capital

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I am pleased to have this opportunity to participate in your meetings, and I thank you for inviting me.

I will be speaking today on the burden of bank regulation, a topic which I suspect is being examined throughout your program. My remarks will focus on two issues, the first of which is the cost of regulation and recent efforts to reduce this burden. Second, I want to discuss capital regulation; in particular, the prominent role of capital in the various provisions flowing from last year's legislation, the Federal Deposit Insurance Corporation Improvement Act (FDICIA).

Reducing the Regulatory Burden

To begin, I know that the cost of bank regulation is a major concern to the nation's bankers. I can assure you that the regulatory agencies are making a sustained effort to reduce this cost because I have been directly involved in that effort. While one always wishes that more could be done, I am pleased with the progress that has been made thus far.

Although we generally believe that the costs of supervision and regulation have been increasing steadily in recent years, there had been few studies estimating the total burden of bank regulation. Now, there is some work on this topic, and I understand more cost studies are underway. The American Bankers Association estimated regulatory costs to be $10.7 billion for the banking industry as a whole. As my colleague John LaWare points out, the true number may be $15 billion or more when deposit insurance premium costs and the opportunity costs of sterile reserves are included. Put another way, the true cost of the regulatory burden may well be a substantial 8 to 16 percent of noninterest operating costs.

The inability to pay interest on required reserves is a major component of total regulatory cost. Although reserve requirements were established originally for safety and soundness purposes and to provide clearing balances, they became a part of monetary policy. Therefore, the desire to lower reserve requirements to reduce regulatory burden becomes involved in the complex of monetary policy questions.

The opportunity cost to the banking system of holding nonearning reserves varies with interest rates. In addition, the opportunity cost is a function of both the level of reserves that would be held absent a legal requirement, and the range of alternative investment choices available to a given bank. Required reserve balances of depository institutions with the Federal Reserve Banks are now about $22.5 billion. At an opportunity cost of 3.1 percent, the federal funds rate for October, the pre-tax cost of reserves would be about $700 million per year. I might note that the Federal Reserve has reduced this opportunity cost appreciably on two different occasions recently. The Board eliminated required reserves on nonpersonal time deposits in 1990 and reduced required reserves on net transaction accounts this year.

Perhaps reserve requirements can again be reexamined over time as transactions and clearing technology improve. Likewise, some day it may be possible to pay interest on required reserve balances held at the Federal Reserve. As you may know, the Federal Reserve Board has recommended this change to Congress.

Bank deposit insurance premiums are the second major component of regulatory cost. Premiums have risen rapidly in recent years and were over $5 billion in 1991. Given the need to rebuild the Bank Insurance Fund, it seems unlikely that there will be any significant decrease in insurance premiums until the fund is fully recapitalized.

While the costs of deposit insurance premiums and the foregone interest on reserves are high, these expenses have to be viewed as part of the franchise cost of being in the banking business. Reserves provide access to the Federal Reserve's payment services and discount window. These are very important to many banks. Insurance premiums permit banks to offer insured deposit accounts. The government safety net has pluses and minuses. On the positive side, although banks suffer from certain competitive disadvantages -- such as geographic and product restrictions -- none of their nonbank competitors has the ability to offer government-insured deposit accounts. On the negative side, there is the regulatory burden designed to protect the taxpayer and the Bank Insurance Fund from the so-called "moral hazard."

Beyond the costs of reserves and insurance, there are the other costs associated with supervision and regulation. These are the costs that the American Bankers Association study estimated at $10.7 billion per year.

Since much of banking legislation is quite specific, there are real constraints on the effort to reduce regulatory burden. But having said that, let me turn to the process of achieving some regulatory relief. I am new at the effort, but have had the opportunity to learn much in recent months about bank regulation generally and about the Federal Reserve Board's processes in particular. Since 1978, the Board has maintained a formal program of regulatory review and simplification. In addition, the Board undertook a review of all its regulations earlier this year to determine how its regulatory processes could be simplified and streamlined within our statutory mandates.

What have these efforts achieved so far? As a result of our comprehensive regulatory review begun earlier in the year, in April, I reported to the Board on steps that the Federal Reserve could take to reduce and simplify regulations. The Board could initiate some actions on its own, and others required the cooperation of other banking regulatory agencies. By September, we had taken action on many of these proposals and other changes were out for public comment. Although some of these ideas may not produce major, clearly identifiable cost savings, even small improvements can help.

Many of these proposals dealt with the more efficient processing of the nearly 3,000 applications that we receive each year. The applications burden can be reduced, and paperwork savings achieved, because many bank and bank holding company applications present no significant regulatory issues. Many times, when an application must be filed, review and approval can be delegated to the Reserve Banks. This saves time at the Board level and, by eliminating one layer in the regulatory process, speeds up the formal granting of an approval. In other cases, we are duplicating the regulatory review done by the bank's primary regulator, and an application to the Board can be waived if there are no significant regulatory issues.

Moreover, some issues have become less controversial over time, and the need for extensive applications has diminished. For example, in the past, many branch office applications were controversial. Other banks protested that there would be overbanking. Now, except for occasional CRA protests, there are seldom any questions raised about branch applications. Thus, these applications should receive expedited treatment as long as the bank meets standard regulatory requirements.

We are also working with the other financial regulatory agencies to standardize and simplify both regulations and the application and reporting forms associated with those regulations. For example, when two or more regulators must review an application, the same application form should be acceptable to both agencies. A bank should not have to fill out two different application forms to obtain one approval.

The regulators can also reduce burden through the better coordination of the bank examination process. Disruption to normal bank operations can be minimized if we can avoid having multiple sets of examiners going through a single bank. We are working on this problem in conjunction with the other regulatory agencies. Standardizing the training of examiners and the interpretation of regulations across agencies should also permit some savings and, by reducing the level of regulatory confusion, lower the burden on banks.

As one other example, we have added a number of nonbank activities to the "laundry list" of activities permissible for subsidiaries of bank holding companies. Once it is established that a new activity is permissible according to the statutory criteria, applications to engage in that business, as long as they are submitted by sound banking organizations, should not require substantial paperwork or lengthy regulatory review.

As most of you are aware, we are now participating extensively in the Exam Council's review of regulatory burden, as required by section 221 of FDICIA. A draft report has been produced and is circulating for comments. We expect that the report will be completed by the December 19th deadline. While I cannot comment on the specific contents of the report, I believe it will offer guidelines for a substantial reduction of regulatory burden. There is a lot that can be done to reduce burden without endangering the safety and soundness of the banking system or harming those who use its services. I hope that all of you will read this report when it becomes available and will react to it, both to your regulators and to your representatives.

I am happy to report that the President signed the Housing and Community Development Act of 1992 last week. While many of the proposed regulatory reforms that the Board supported did not make it into this bill, there were some provisions that did. For example, the new law allows the regulators to adopt a $100,000 exemption for real estate appraisals, and allows the regulators to establish thresholds below which a licensed or certified appraisal is not required if there is no threat to safety or soundness.

In another important area, the new law clarifies the FDICIA provisions on executive compensation. In particular, regulators are instructed <u>not</u> to set a specific level or range of compensation for bank officers, directors, or employees, as appeared to be called for in FDICIA. This clarification, however, does not affect the regulators' authority to restrict the compensation of a senior executive of an undercapitalized institution.

Other provisions in the new law delay compliance with Truth-in-Savings for three months, exempt on-premise signs from the advertising disclosure requirements, reduce the burden of regulations on real estate settlement procedures, and increase regulatory flexibility in the review of insider loans. These are clearly improvements, but broader reform in terms of regulatory burden or a meaningful expansion of bank powers must await another legislative session.

Thus, we have seen some progress this year. We have achieved some burden reduction from the banking agencies' regulatory relief effort, we expect regulatory savings to result from the FFIEC's study of regulation, and we have won some gains from the recently signed legislation. But, there is certainly a great amount of regulatory burden remaining.

Indeed, the regulatory and legislative processes need to be examined closely and continually in terms of cost/benefit analysis. Sometimes, there are perceived problems that are not, in reality, significant problems, or there are problems brought about by the abuses of a few institutions. In looking at new regulatory or legislative proposals, we should all ask ourselves questions such as: How many banks are guilty of a particular questionable practice? What is the cost to the system and society of allowing this practice to continue? What is the cost of attempting to control the practice by regulation, rather than supervision? Will the proposed regulation duplicate other regulations? Will attempts to control this behavior be successful? And at what cost? Would limited supervisory resources be better deployed in investigating other banking practices? And, on the other side of the equation: What are the benefits? What is the value of the benefits, and how can they be measured against the cost?

These questions are difficult to answer, and often not enough is known to make accurate assessments. So, instead of making these calculations, often a law is passed or a regulation is put in place without adequate cost/benefit analysis. Sometimes the law is detailed and specifies precisely how the regulatory agencies are to deal with the situation. At other times, the law is vague and the regulators have to try to determine the intent of the Congress and the best way to carry out that intent. In either case, however, the costs of regulation are born by the stockholders of the banks that are regulated, by the bank customers, who pay higher prices or receive lower returns, and by the taxpayers who, at least partially, fund the regulatory agencies.

To be quite fair, regulatory restrictions had their genesis in attempts to correct a perceived problem or inequity, or to provide certain types of benefits. For example, based on the costs of the savings and loan disaster, there were a number of incentives to take actions to prevent the same type of collapse in the banking industry. Many of the provisions of FDICIA were designed to make sure that banks don't go the way of the savings and loans.

To take another specific example, Congress is now faced with strong statistical evidence, presented in the Home Mortgage Disclosure Act (HMDA) data and in the Federal Reserve Bank of Boston study, that minorities are more likely to be denied credit. The evidence may not be statistically perfect, but the Boston study does correct for some major flaws in past studies. Most importantly, it makes it very hard to imagine that Congress would repeal or weaken significantly the Community Reinvestment Act (CRA), the Equal Credit Opportunity Act, or HMDA. These laws certainly create some of the most burdensome, time-consuming and costly regulations. But, while there is convincing statistical evidence of discrimination, can the burden be reduced?

In the short run, there may be ways to lessen the burden of laws such as the CRA, especially on those banks with a good CRA record. We continue to support legal and feasible methods of reducing the law's burden on those banks. But, in the long run, the responsibility is yours. The banking industry must devise loan application systems and training programs to guarantee that all loan applicants are treated equally.

For the Board's part and more generally with regard to regulation, we are aware of the high and rising dollar cost of the regulatory burden, and we are attempting to lower that cost by reviewing and simplifying regulations. We will continue to urge the Congress to avoid unnecessarily adding to that burden. At the same time, however, the industry must exercise caution in its behavior so as not to provide additional justification for the micro-management of the banking industry.

<u>Capital Regulation</u>

Now I would like to switch from regulatory burden in general to the more narrow issue of the role of capital regulation and its burden. I have chosen to focus on capital because it seems to be the centerpiece of much of the current and proposed regulatory structure coming out of FDICIA. In fact, many argue that FDICIA served to increase the burden of capital regulation. I understand this point of view, but am not sure I agree with it. To analyze this argument, let me talk for a few minutes about capital regulation and its role in FDICIA.

First, there are the capital based prompt corrective action provisions which, I understand, the Board strongly supported. Each bank is assigned a capital "zone" depending on its risk-based capital and/or leverage ratios. Once a bank falls into one of the three "undercapitalized" categories, a host of mandatory and/or discretionary sanctions may be imposed by the supervisory agency. Among the mandatory provisions are: restrictions on dividends, a required capital restoration plan, restrictions on asset growth, restrictions on executives' bonuses and raises, and in the case of critically undercapitalized banks, mandated conservatorship or receivership. Chief among the discretionary sanctions available to the regulator are removal of management, termination of activities, and mandated recapitalization or merger.

These sanctions were designed to give banks powerful incentives to maintain strong capital positions, and, more generally, to prevent the Bank Insurance Fund from being exposed to excessive risk. However, it is important to remember that virtually all of these options were available to the supervisors <u>before</u> the passage of FDICIA, in the form of cease and desist powers. FDICIA simply removed some, but not all, of the supervisors' discretion. In addition, the four regulatory agencies must have common definitions of the capital levels at which various prompt corrective action sanctions will be applied. This standardization approach may actually be desirable. Since a prescribed capital level now results in a prescribed set of sanctions regardless of which agency is the supervisor, banks now have more certainty in their oversight. At the same time the legislation provides for enough supervisory discretion to allow for differences across institutions that may not show up in the capital measures.

Second, FDICIA places new capital-based restrictions on brokered deposits. Only well capitalized banks may raise funds via the brokered deposit market without restrictions. Adequately capitalized banks must obtain a waiver from the FDIC. Undercapitalized institutions cannot issue brokered deposits.

Third, the law provides new restrictions on deposit interest rates. Banks that are not well capitalized are subject to what essentially amounts to a new version of Regulation Q. Interest rates on their deposits cannot be more than 75 basis points above prevailing local rates, or prevailing national rates in the case of wholesale deposits.

Fourth, interbank risk exposures are to be regulated. FDICIA requires the Federal Reserve Board to prescribe standards that limit a bank's risk from its exposure to other banks. These risks of loss result from correspondent balances, swaps, and other interbank liabilities. The Board has proposed such a regulation which would require all banks to track their exposure to other banks. The proposal would set up benchmark standards for limiting exposure to a bank's correspondents that are not well capitalized. Our staff is in the process of reviewing the public comments that were received.

Fifth, FDICIA removes insurance coverage on a pass-through basis to certain deposit accounts held in conjunction with employee benefit plans <u>if the bank in question may not accept brokered deposits</u>. Thus, as a practical matter, only well capitalized banks, or those with an FDIC waiver for brokered deposits, can continuously raise funds in the employee benefit plan deposit market.

Sixth, access to the discount window is curtailed for undercapitalized banks, and access to the window may be eliminated for critically undercapitalized banks.

Finally, FDICIA requires that the capital standards be reviewed biennially by each of the agencies. Moreover, the agencies are to revise the risk-based capital standards to "take adequate account of" interest rate risk, concentration of credit risk, and the risks of nontraditional activities.

As you can tell from my recitation of the capital "burden" associated with FDICIA, I am skeptical of using capital standards to deal with every nuance of the supervisory process or to dictate prudent business practices. There is also some amount of duplication inherent in the FDICIA provisions. For example, certain potential abuses covered by FDICIA are also treated within the examination process. The growth of undercapitalized banks is controlled by the new interest rate caps on deposits, by the new pass-through insurance coverage provisions, by the prompt corrective action sanctions, and by the growth restrictions in the banks' approved capital restoration plans.

Nevertheless, I believe capital standards are an appropriate centerpiece for some regulatory programs. After all, we do not want to see a repeat of the troubles of the past. Also, I think capital standards can be used to reward less risky banks with a reduced regulatory burden, and more tangible benefits such as lower risk-based deposit insurance premiums. Perhaps, some expanded powers can be tied to whether a bank is well capitalized. But, capital should not be seen as a panacea -- there are many other aspects of banking which contribute to a bank's success, not the least of which is management.

As I've indicated earlier, the banking system has a safety net stretched beneath it consisting of the full faith and credit of the government on insured deposits, and direct access to the Federal Reserve's discount window and payments system guarantees. This safety net, if it were not accompanied by prudential regulation, including tough capital standards, would expose the taxpayer to significant risk.

How burdensome are the capital standards? Our data show that more than 11,000 banks, comprising more than 93% of institutions, meet the definition of well capitalized banks under the standards recently promulgated by the agencies. To a large extent, these banks are not burdened by the capital standards, although individual members of this group may have asset or other weaknesses that subject them to supervisory actions, prompt corrective action sanctions, and other provisions of FDICIA. Indeed, historically, a large portion of the industry's institutions have maintained capital well in excess of standards set by the regulators, recognizing the need for strong capital.

The significant capital burden will be imposed mainly on the 233 banks in the three undercapitalized categories. These institutions fortunately hold less than 2 percent of the total assets in the banking system. There is also a capital constraint imposed on the 520 banks that are "adequately capitalized." These institutions constitute less than 5 percent of the banks, but hold more than 30 percent of the system's assets. This group of banks will have to maintain or improve their performance in order to ensure they do not fall into the ranks of the undercapitalized.

Given the data just presented, capital regulation currently does not appear to be overly burdensome. Moreover, the burden is distributed where it should be -- on the banks that, left to their own devices, have not maintained adequate capital, thereby exposing the Bank Insurance Fund, other banks, and the taxpayer to unnecessary risk.

Conclusion

In conclusion, I hope my comments have demonstrated my acute interest in studying and attempting to reduce unnecessary regulatory burden. I hasten to add that total regulatory burden can never be eliminated, nor should it be. But the regulatory burden can be subjected to more stringent cost/benefit analysis. Such analysis should be on a continuing basis, reflective of changing economic and technological conditions. Just because "we've always done something this way" or because "it ain't broke" doesn't mean it can't be made to work better. On the other side of the cost/benefit equation, we should not ignore the benefits. As difficult to quantify as costs are, benefits may be even more difficult to measure. Yet it is often the benefit side which drove the passage of the law or establishment of the regulatory program. Thus, proposals for change must concentrate on both costs and benefits.

I thank you for your attention, and will be interested in your reactions to my remarks.