Regulatory Burden from a Regulator's Perspective

Address by

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Thank you. It is a pleasure to be here today to discuss the issue of regulatory burden from the perspective of a Federal Reserve Board Governor. My old friend Rob Rowe of ABA's Washington Office tells me that most of you are responsible for reading and interpreting for your institutions all of the new regulations we are issuing. On the assumption that misery loves company, I hope it will make you feel a little bit better to know that my colleagues and I have to read all of those documents before we send them out to you. In any event, I'm sure your bosses have recognized all of the extra work you've been doing and have given you a raise proportional to the increased paper flow. No? Well maybe when you return you'll be sure to mention that you heard the issue raised by a Federal Reserve Governor.

Unfortunately, the problem we face with the banking industry's ever mounting regulatory burden is no laughing matter. As my colleague John LaWare told the Congress earlier this year, "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."

Today my task is twofold: to provide a perspective on regulatory developments and to make some suggestions on what banks might do to relieve some of the regulatory burden. The focus of my remarks will be on the types of regulations I deal with as Chairman of the Board's Committee on Consumer and Community Affairs. These regulations -- the Community Reinvestment Act (CRA), the Home

Mortgage Disclosure Act (HMDA), the new Truth in Saving rules, and fair lending practices seem to be the primary focus of bankers' complaints about regulatory burden. However, I do believe that it is important to put these rules in the larger perspective of regulation generally.

Quantifying regulatory burden has become a bit of an industry unto itself. The ABA has estimated that regulatory burden in 1991 amounted to $10.7 billion, about 10 percent of operating expenses and 59 percent of profits. The IBAA rated the 13 most costly regulations as costing roughly 28 percent of income. The FFIEC, Federal Financial Institutions Examinations Council has estimated regulatory costs to be in the range of 6 to 14 percent of noninterest expenses.

While I applaud these efforts to estimate regulatory burden, all face a key methodological hurdle. To what state of the world should these regulatory costs be compared? Should our counterfactual baseline be the complete absence of regulation and supervision? I don't think so. The industry itself, not to mention its customers, benefit from safety and soundness supervision. The wonders of our modern payments mechanism -- millions of checks and billions of dollars moving each night -- requires some basic faith in the soundness of the institutions participating in the process.

Regulatory burden therefore emerges not from the mere presence of a bank regulator engaging in a supervisory function. I strongly suspect that in the absence of our state and federal bank regulatory bodies, the industry would adopt some kind of self regulation. Zero regulation is therefore not an appropriate baseline for comparison. Realizing this conceptually, let us call our hypothetical baseline level of regulation the "minimalist" approach.

On the other hand, in recent years the banking industry has seen a substitution of regulation for supervision. Regulation entails formal rules being codified and universally applied, and thus less subject to interpretation given a particular institutional setting. In addition, we have had a spate of increasingly specific and prescriptive legislation which limits the leeway of regulatory bodies in interpreting Congressional intent. Far from being minimalist, we are on the verge of a maximalist approach to regulation, where increasing amounts of the detail of bank policies are being made in the legislative arena. The ultimate result of this maximalist approach is to turn banking into the equivalent of a regulated utility.

Left unchecked, the end result of this process will be a weaker and less resilient industry with fewer choices available to the consumers of banking services. The increasingly prescriptive approach Congress has taken toward banking regulation is no doubt well intended. But nothing has been more obvious to me in my 19 months on the Board as the possibility that well intended legislation and regulation may have unintended, often pernicious consequences.

Indeed, while those who would try to measure the regulatory burden have a conceptual problem in seeking a base of minimalist regulation, supporters of the maximalist view of regulation also have a problem. They implicitly argue that anything that goes wrong in the world must be the result of an inadequate level of regulation. Their view assumes that the ideal we must achieve is an error free world. They assume that a perfect world, with an ideal set of regulations, is both achievable and desirable. With the luxury of 20-20 hindsight these supporters of regulation criticize the errors of those who had to deal with challenges before the fact, not after the outcome was known.

Specifically, let us consider two of the regional banking disasters of recent years: Texas and New England. Let me state up front that in both instances there were some shady operators and some folks who were downright foolish. That is always the case and those people will, if the system works right, find themselves either in court or in bankruptcy. But in neither case were either crooks or fools the majority of the players. And in both cases virtually an entire industry was wiped out.

In Texas, the root cause of the collapse was a sudden and unexpected decline in the price of oil from $30 a barrel to $6 a barrel. Granted, any banker who financed a deal on the assumption that oil would go to $100 should be criticized. But does that mean that everyone should have had perfect foresight on the collapse? Could regulators have predicted such a phenomenon? In fact, the U.S. Department of Energy did not foresee the collapse. How could we possibly expect even the most talented and omnipotent bank regulator to have done better?

Or, consider New England, in which I had a bit of a personal stake. In October 1988 I had published in the New York Times a piece entitled "Massachusetts: Miracle or Mirage?", in which I opted for the mirage, a distinctly minority view. And so the next Spring, my wife and I took the first offer we got on our house, in spite of having the real estate broker tell me to hold out for more. Given the general decline in housing prices, one of my firmest wishes is never to run into the couple we sold the house to. Here was a case, in retrospect, of a clearly unsustainable bubble based on a temporary defense buildup. Yet, the "miracle" story not only fooled the bankers and the bank regulators, it propelled the Governor of the state to his party's Presidential nomination, and led to glowing stories in the nation's media. Even the stock market was fooled. Those New England banks which were the most aggressive were trading at a premium as late as the Spring of 1989. Again, is it reasonable to expect even the most talented regulator to have known better?

I therefore believe that the best role for a bank supervisor to play is as a second opinion or second judgment. I am told by folks who have been in the industry a long time that that is the way it used to be; that many bankers often welcomed their examiners as an opportunity to gain some additional insight. Today it might seem difficult to imagine that such a world ever existed. But when it did, the term "regulatory burden" was not heard. The correct phrase would have been "regulatory benefit".

The proper design of regulation, from this regulator's perspective, is to return wherever possible to this earlier model. A second judgment, or second opinion, is just that: it is not perfect, but it does carry the weight of experience and of comparison across institutions. However, judgment ceases to be such when it is mandated from above. Judgment necessarily involves examination of the detailed circumstances in which a given loan is made. When rules replace judgment, costs are incurred.

Consider a couple of examples. Recently the Board of Governors and the other financial regulatory bodies proposed to raise the threshold amount of a loan for which the use of certified or licensed appraisers was mandatory from $100,000 to $250,000. These appraisals relate to Title XI of FIRREA. As you all know, they were costly to banks and their customers alike. A $500 appraisal on a $100,000 home with 20 percent down is the equivalent of asking the buyer for another month's mortgage payment. How many American families, at the margin, could not become homeowners because of the original $100,000 requirement? What was gained? Do we really think that the appraisers, even certified and licensed ones, will predict the next Texas or the next New England? Do we really think that these people care more about the fate of a loan than the loan officer whose job is at stake or the bank whose profits are at risk?

Even more pernicious in my view were the regulations related to loan to value ratios which were issued last year. What we ended up with was much improved over the original proposal. The original proposal, for example, mandated maximum loan to value ratios on single family owner occupied homes of 80 percent. In other words, every family would have had to put 20 percent down on their homes. This would have devastated the ability of low and moderate income families, who often have trouble coming up with closing costs, from acquiring homes. Our staff estimated that some 9 million American families would have been frozen out of homeownership by the new rules. What were the benefits? At no time was concrete evidence presented that a 20 percent downpayment requirement was a cost effective way of minimizing delinquency costs. Fortunately, the rule was changed. Still, we have established rules that treat all farmland the same for loan purposes whether it is threatened by wetlands regulation or protected under price support programs. Surely this cannot be good regulation.

Why then do we have all this highly prescriptive legislation in the first place? I think the phrase, "there oughta be a law" sums it up nicely. We Americans, confronted with an outrage, seem to instinctively seek legislative relief. Frequently the outrage to be legislated against is simply a symptom of a wider problem which may go unsolved. Again, the basis for comparison is the maximalist interpretation of the "correct" state of nature. If something goes wrong, then the right approach is legislation to fix it.

I believe that this is also the reason why we have recently seen a revival of legislative activity on the consumer front. There is no question that outrages exist. The maximalist response to these outrages is legislation intended to make sure that these problems do not happen again.

Consider a prime example which has recently come on line: Truth in Saving. This legislation had remained dormant in the Congress for years. But, during 1991, the practice of some banks paying interest using what they called "the investible balance method" became widely criticized. The case for this method was that reserve requirements limited the amount of any deposit that could be invested in loans or securities. So, given a 12 percent reserve requirement, only 88 percent of the funds could earn money for the bank. These institutions decided to change policy and pass this along to the customer. So a 5 percent account using the investible balance method would pay only 4.4 percent.

This is an outrage, and Truth in Saving moved through Congress in large part because it outlawed the procedure. Customers should not be told their accounts pay 5 percent when in fact they pay 4.4 percent. I would call this a true case of "Falsehood in Savings" which Truth in Savings legitimately corrects.

Unfortunately, the law went further. Its purpose, admittedly well intentioned, was to make the stated yield on all accounts comparable, thus allowing the consumer the opportunity to comparison shop with ease. What we have learned in writing the regulations is that life is not so simple. Consumer saving products differ not only in the rates of interest they pay, but in the period of compounding used for those rates and the time at which money becomes available on those accounts. The result has become nightmarishly complex as we search for a "right" answer where arguably there is none.

Let me give an example. Two banks offer a "5 Percent Account". One pays you $50 on every $1000 you deposit on the year anniversary of your deposit. Another sends you a check automatically for $12.50 every 3 months. Are these accounts the same? Both depositors have earned $50 at the end of a year. But, if there is any time value to money, receiving $12.50 every 3 months is clearly better than waiting a whole year to receive $50. Shouldn't the every 3 month account show a higher yield since in effect, the money compounds quarterly? This raises other questions. Should it matter whether the customer has the option to reinvest the interest in her certificate of deposit and thus compound along with the original principal? If withdrawn, what time value of money should be assumed? The list of questions is as endless as the possible number of ways to market a product.

Or, consider the phrase "free checking". We can all agree that this probably means no monthly maintenance fee or per check charge. But what about the fee for printing checks? Can an account be "free" if it is subject to a minimum balance? Does having a free checking account automatically mean unlimited free use of a bank's automatic teller machines? What about free use of other A.T.M.s? The law requires us to give a definitive answer to each of these questions.

Let me tell you, our phones have been ringing off the hook as each permutation is questioned. Here is an aspect of regulatory burden that is not measured, and may not even be measurable. If, for example, we decide that a free checking account does not imply free use of foreign A.T.M.s, then what happens to those banks who offer this service? Bank A, with free foreign A.T.M. service, gets no advantage when Bank B can advertise an equally "Free Checking" account without that service. The market result is to reduce customer service to the lowest common denominator -- that defined by the regulator.

Furthermore, this loss of consumer benefit is not just a one time static loss when the rules are implemented. There is a permanent loss of competition through innovation. When a new product comes along, say banking by phone or by computer, what incentive does any bank have to offer the service if it is not required by the regulator?

Let me give a second example of an outrage that is now in the process of creating new legislation. You are probably all familiar with the stories arising out of Atlanta and Boston of abusive lending practices to low and moderate income residents. Contractors would appear with "pre approved credit" for home repairs or cash loans. The actual contract terms often involved outrageous points and/or interest rates and some of the individuals involved lost their homes as a result. The practice has earned the name "reverse redlining".

I have met with some of the victims of these scams, and I find the way these individuals were treated to be totally outrageous. One loan was approved in which the borrower signed the disclosure statement with an "X", instead of her name. Another signed even though her monthly payment was more than her income. Tell me, do you think that the person making that loan should be able to call himself a "banker"? Even forget, if you can, the moral outrage involved and consider only the safety and soundness responsibilities of the job. Surely the individuals approving these loans must have had their suspicions aroused.

Of course, the Congressional response has been predictable: legislation designed to protect folks from abusive practices, including more disclosures. Frankly, I have my doubts that any amount of disclosure would have helped the lady who signed with an "X" or even the individual who saw on the disclosure that her monthly payment was more than her income. I also testified that I felt that some legitimate lending might be stopped by the law in its present form. But let me say that I fully concur with the members of Congress who are totally outraged by such behavior and are frustrated that we have a banking industry that let such practices occur.

One of my tasks today was to suggest how regulatory burden might be reduced. How can we prevent the maximalist model of regulation from reducing banks to regulated utilities? I have suggested that zero regulation is not the right alternative. Instead, I recommended the minimalist approach. Key to that approach is judgment. We are in the process of substituting rules for reason and punitive justice for judgment because reason and judgment have not been used in the past. No banker I know who used reason and judgment would have adopted the Investible Balance Method of compensating his customers. No banker I know who used reason and judgment would have actively solicited a high interest loan from someone who is clearly unable to meet the payments.

So when we denounce the regulatory burden that we now face, when we criticize the loss of incentives for innovation, and complain that it is the consumer who is paying the real cost of excessive regulation, we had better have a workable alternative in mind. A market based solution which is full of abuses is a contradiction in terms. A service industry, like banking, which does not serve its customers, or which operates in a vacuum of reason and judgment will soon find the vacuum filled by legislative fiat.

Before ending today, I would like to turn to the area of banking activity that I see as having the greatest potential for further legislative and regulatory activity: fair lending. It is also the area in which the opportunities for the banking industry are the greatest. There is no area more fraught with emotion. Nor can I imagine anything more important to the fundamental values we all believe in. Discrimination tears at the fabric of our democratic society. It also tears at the fabric of our faith in capitalism and the market. One of the great advantages of the market is that it is supposed to be color blind. If that turns out not to be the case, then the foundations of our economic system as well as our political system are at risk.

Recently, I was accused in the American Banker of engaging in "politically correct theatrics" on this subject. Those who know me know that I do not have a politically correct bone in my body. So, let me turn to the facts and the reasoning I use to reach my conclusions.

The Federal Reserve Bank of Boston ran what is certainly the most comprehensive statistical analysis of lending patterns by race that has ever been conducted. That study found that what I would call "old style" discrimination did not exist. That is, clearly qualified applicants of any race were approved for loans and clearly unqualified applicants of any race were rejected. The days when members of minority groups who meet all of a bank's criteria for lending are rejected anyway, seem to be gone. I believe that is why bankers believe so strongly that they do not discriminate.

However, what the study also found was that a careful statistical comparison of applicants who were less than ideal indicated that imperfect white applicants were more likely to be approved than imperfect black applicants. Three types of explanations for this have been advanced. First, some have argued that the results are proof that racism still exists in our society and in the banking industry. From a statistical point of view, there is no way that this hypothesis can really be tested. It may be true. My own judgment is that while some racism may exist, it is probably not the dominant factor in bank decision making. The institutions in question all have stated policies against discriminatory practices, and the extent of discrimination found, which affects roughly 6 out of every 100 minority applicants does not comport with racism as dominating the process. I say that reiterating what I said above, that any amount of discrimination is totally unacceptable.

The second hypothesis is that there is no racism in the process, that in fact the banks have gotten their lending practices about right. What is missing from the Boston study is a careful look at the long term default risks on these loans. It is true that the Boston study did not go into a detailed examination of the actual loan files to see if some other explanation for rejection existed. Where this has been done, some of the disparate rejection rate has been explained. But, ultimately this hypothesis, like the racism hypothesis, cannot be statistically tested. We cannot tell today what the ultimate outcome of the loans we make today will be. So, like the first hypothesis, I accept that this one might well be the case, but that the evidence before me today suggests that it is not.

The third hypothesis is that some racially disparate loan practices are occurring in spite of bank policies to the contrary. This hypothesis not only comports with the Boston findings, it also suggests that relatively minor adjustments in institutional behavior will be appropriate remedies. The Federal Reserve Bank of Boston has recently put out a pamphlet on these remedies called Closing the Gap: A Guide to Equal Opportunity Lending which I commend to all individuals in the financial services industry.

Let me also stress that as long as behavior exists which appears outrageous to reasonable individuals, the threat of legislative and/or regulatory action, with all of its attendant burdens remains likely. Banks have a responsibility not only to end the practice of discrimination, but end the appearance that discrimination is occurring as well. As long as large numbers of minority customers remain dissatisfied with the treatment they receive, greater regulation remains a likely prospect. Or, as President Jordan of the Federal Reserve Bank of Cleveland has argued, "This problem is not solved until everyone agrees it is solved."

The prospective regulatory burden which will result from not solving this problem is enormous. The ultimate remedy is to completely replace bank judgment and reason about loan approval with statistical rules. I fear that in some instances, the use of statistics to establish discrimination may go too far. At the Federal Reserve we are using computer based statistical models as a part of our examination process. However, these models are only used to select particular loan applications to examine more closely. The statistical models in and of themselves will not, and should not, be used to determine whether discrimination exists. Instead, the computer will select individual matched pairs of actual applications to be examined. We believe that this will improve the examination process by reducing the randomness in selecting applications to be examined.

The potential overuse and abuse of statistics in this area threatens the imposition of a burden in at least two ways. First, the use of statistical models as the sole criteria when the details of such models are unknown to the banks being examined means that no bank can know what rules it actually has to comply with. It would be like replacing the speed limit on our nation's highways with some computer determined "Conditions Adjusted Velocity" formula in order to enforce traffic laws and not tell motorists what the Conditions Adjusted Velocity formula was. Laws can only work if people know what they have to do to obey them.

Second, the likely result of statistics based examination of loan approvals is statistics based approval of loans. This, in turn is likely to work against individuals who do not meet the "normal criterion" of a one-size-fits-all statistical rule. One need only look at the historic performance of the secondary market to see that minorities and other disadvantaged groups find themselves only further disadvantaged by such a practice.

One returns to the ultimate limitations of legislation and regulation as a form of industrial structure. The foresight and insights of the legislator and regulator are not apt to be any greater than those of a normal, well meaning, individual. Just as a regulator could not foresee the collapse of the price of oil or the end of the Massachusetts miracle, they cannot be expected to foresee changing demographic or economic conditions. The law of unintended consequences will continue to hold sway.

The real solution to regulatory burden in this area, as in other areas, is a return to reason and judgment. In the purest sense of the word, discrimination means that an otherwise profitable sale is passed up by the seller. This is not good banking. Although no one has ever established that markets work perfectly in all instances, markets do offer us the opportunity to adjust to changing conditions, foresee the unexpected, and avoid unintended consequences as well as any other system yet devised. When public faith in the judgment and integrity of the key players in markets returns, so will a reliance on their reason. When that day comes, the issue of regulatory burden will take care of itself.