# "The Banking Regulatory Environment--
# Burdens and Opportunities"

Remarks of

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New York State Bankers Association
Annual MidWinter Meeting

January 28, 1993

Washington, D.C.

I am pleased to have this opportunity to participate in your Annual Midwinter Meeting here in Washington.

This year will be a challenging and perhaps frustrating year for many banks as they respond to the needs of an expanding economy and face the new regulations required by the FDIC Improvement Act. FDICIA has been widely criticized in many quarters for its extensive and perhaps intrusive provisions. Although I believe that a good bit of that criticism is warranted, I would also suggest that most individual elements of the law probably can be separately defended. If you stop to think about it, somebody wanted each part of that legislation for some reason. The major problem with FDICIA relates to the cumulative effect of numerous new requirements, especially when added to an already large collection of existing banking laws and regulations. While it is clear that some changes might have been needed in the operating practices of both the regulatory and banking communities, we all need to be mindful of the growing toll these laws and regulations take on bank efficiency and on the ability of banks to compete and serve the nation's financial needs.

In my remarks today I would like to discuss certain aspects of FDICIA and other regulatory initiatives and their implications for regulatory burden. I will also comment on the direction I believe future banking laws and regulations might take and the recent progress the banking system has made.

**Prompt Corrective Action**

A key element of FDICIA is prompt corrective action. So let me begin with that. I might mention that prompt corrective action is a concept that received the support of the Federal Reserve during the legislative debate leading up to FDICIA's passage. Maintaining adequate capital levels is essential to the sound operation of banks. Prompt and decisive supervisory actions will be taken if capital becomes inadequate. That message should be loud and clear by now.

Fortunately, given the improved condition of the banking system, the December 19th effective date of prompt corrective action was virtually a non-event, despite some earlier speculation to the contrary. On that date, regulators were directed to take specific actions against banks with inadequate levels of capital. In short, although nearly 200 banks have been required to submit capital restoration plans and eliminate their dividends, not one has yet been closed as a direct result of FDICIA. Moreover, all of the 200 banks were already operating under some formal supervisory action.

Indeed, while prompt corrective action is a useful organizational concept, it is important to remember that virtually all of the options now available to regulators were also available before passage of FDICIA through cease and desist powers. FDICIA simply removed a good bit of the supervisor's discretion. The principal new feature provided by FDICIA is that regulators can now take control of an institution before determining that it is technically insolvent. We will need to see how often that potentially important new power is used.

When considering the requirements of prompt corrective action, I would note that simply meeting the published standards for capital ratios does not ensure that a bank is "home free." The law also permits supervisors to downgrade a bank on the basis of factors other than capital, although within some limits. This ability to downgrade is likely to increase materially the number of banks that are treated as under-capitalized. For example, at the end of December there were about 850 problem banks, but only about 200 of those banks were not "well capitalized" based on published ratios. Depending on their specific situations, some of these problem institutions may be candidates for downgrading.

When enacting FDICIA, the Congress chose to center the legislation around the importance of bank capital. While clearly important, the focus on capital should not be exaggerated. Capital is not a panacea. Good bank management remains the central requirement for success in today's competitive and regulatory environment. And from the regulatory perspective, capital cannot be used to deal with every nuance of the supervisory process or to dictate prudent banking practices. Examiner judgements and other supervisory elements must continue to play important roles. As used in FDICIA, capital standards determine when to use the so-called regulatory "stick." I hope that future laws and regulations would also use capital as a "carrot" to reward less risky, and well-capitalized banks with greater powers or fewer regulatory costs. The FDIC's risk-based insurance schedule is a useful step in that direction.

The fact that so many problem banks report relatively strong capital ratios illustrates another problem that regulators face when evaluating the quality of bank capital. That is: how to assess the adequacy of loan loss reserves. This has always been a difficult issue and will continue to be a challenge in the years ahead. Current banking and supervisory practices in this area need to be improved. Otherwise, the prompt corrective action provisions will contain a large loop-hole. To address this concern, the Federal Reserve and other banking agencies are placing a high priority on providing bankers and bank examiners with additional guidance on evaluating reserves.

**Other Important Provisions of FDICIA**

Since almost 99% of the banking industry is within either the adequately capitalized or well-capitalized zones, prompt corrective action directly affects few institutions. For most banks, the other provisions of FDICIA are much more important -- including the requirement for annual on-site examinations, and the new safety and soundness standards under section 132, to mention a few.

The requirement for annual full-scope examinations, like prompt corrective action, is one that the Federal Reserve supported. Frequent examinations have long been a key element of the Fed's supervisory structure, and adoption of the practice by all agencies should help strengthen the banking and supervisory system. Only through on-site reviews can we evaluate the expertise and understanding of bank management, the adequacy of systems and controls, and the extent to which bank and regulatory policies are implemented. Relying solely on reported data and on limited-purpose examinations has simply proven to be insufficient.

Section 132, which requires regulations on sound operational and managerial practices, is probably the part of FDICIA that has caught the most arrows--from bankers and bank regulators, alike. The law directs us to develop standards for a host of activities, including internal controls, loan documentation, credit underwriting, asset growth, compensation, and such other operational activities deemed appropriate. Failure to meet these standards to the satisfaction of an examiner can subject a bank to a variety of supervisory restrictions, including curtailing its asset growth or strengthening its capital ratio.

It is more than a mild understatement to say that it is difficult to develop regulations on operational and managerial practices to cover circumstances of nearly 12,000 financial institutions with assets ranging from a few million dollars to $200 billion. Simply put -- some flexibility is needed. Accordingly, as the Federal Reserve and the other agencies develop implementing regulations we are trying to be mindful of the industry's needs and the cost of excessive regulations. But we must also be responsive to Congressional intent.

There are other provisions of FDICIA dealing with accounting and capital standards and a host of other matters that will impose other new costs on the banking industry. Although we can try to minimize some of the negative effects, one cannot deny that most new laws and regulations mean higher industry costs. With that thought, let me turn to the issue of regulatory burden.

**Regulatory Burden**

I know that the cost of bank regulation is a major concern to the nation's bankers. It is also one that the Federal Reserve takes seriously and has spoken out against at many opportunities. One of my specific responsibilities as a Board Member has been to lead an internal review of the Fed's regulatory programs to see where changes might be made to make our programs more efficient and less burdensome within statutory constraints. Therefore, the topic of regulatory burden is clearly one of great interest to me.

The American Bankers Association has estimated the annual regulatory costs to the industry at nearly $11 billion. Adding the actual or opportunity costs of deposit insurance and sterile reserve balances at the Federal Reserve, my colleague Governor LaWare has cited a cost closer to $15 billion, and other estimates show the costs higher still. I understand that more studies are still underway. Although some of these costs could be viewed as part of a franchise fee associated with the banking business, and the price of government insurance, they are by any measure substantial. Moreover, even these costs cited are only the "direct" financial costs of U.S. bank regulations. There are other regulatory opportunity costs to the industry, such as the geographic and product restrictions that apply to banks but not to much of their nonbank competition.

Since most banking legislation is quite specific, there are real constraints on the ability of the regulatory agencies to reduce burdens in a meaningful way. That was the central message that we gave to the Congress when we testified on this topic last summer. It is also the point that we confront time and again during our in-house efforts directed toward reviewing regulations and removing unnecessary requirements.

As some of you may know, the Federal Reserve has an on-going program to review and simplify regulations. That formal program has been in effect since 1978. In addition, pursuant to section 221 of FDICIA, last year we also worked actively with the other banking agencies and the Treasury Department to identify unnecessary requirements imposed by all of us on banks. That effort alone revealed more than 60 specific initiatives that the agencies could undertake to reduce the industry's burden.

Recommendations for change include procedures for closing ATMs, regulatory accounting standards, application processing, bank and thrift capital standards, CRA requirements, and a host of other things. These findings and recommendations were published last month by the Federal Financial Institutions Examination Council (FFIEC) in a report entitled "Study on Regulatory Burden." If you are not familiar with it, I recommend it to you. It marks the beginning of an effort that will expand into a review of possible changes to current banking laws.

Going forward, both the regulatory and legislative processes should continue to be examined closely in terms of cost/benefit analysis. Sometimes, perceived problems are not significant ones, or they relate to only a few institutions. When considering new legislation, we should all ask ourselves: How many banks are guilty of a particular questionable practice? What is the cost to the system of allowing the practice to continue? Should it be controlled by regulation or by supervision? Will proposed regulations accomplish their goal? At what cost to the banking system, to society, or to the borrowing public? On the other side, what are the benefits? How can they be measured against the costs?

For too long, demands have been placed on the banking system in the belief that they are cost-free. They are not. Someone--either bank customers or depositors or the general public--pays the price. We should ask whether it is a cost we are willing to pay.

At the same time, we should not lose sight of the benefits. We should not be guilty of concentrating only on the costs. It is the benefit side of the equation which often drives new legislation. So analyses to initiate regulatory or legislative change must concentrate on both sides -- costs and benefits.

To put these assertions into a particular context, some obligations probably are necessary if everyone is to have equal access to banking services. While not perfect, new evidence suggests that minorities remain more likely than others to be denied credit, when income and other factors are the same. With such findings, it seems unlikely that the Congress would repeal or otherwise weaken provisions of the various consumer-related banking laws until there is visible improvement in the home mortgage data.

**Bank Lending**

The past problems of the banking system, combined with FDICIA and other laws and regulations, have clearly affected the activities of commercial banks. Some of the results have been positive: capital and earnings have improved, and bank stock prices are up. Other developments, however, have not been so good: failing and troubled banks, and in recent years, what some have called a "credit crunch."

None of us wants a bank to fail or to conduct unsafe activities. However, neither do we want banks to become overly cautious, stifling economic growth. Unfortunately, actions to enforce prudence can sometimes go too far -- whether by regulators or by bankers themselves. Overly cautious policies may avoid the threat of future costs to taxpayers, but are not without costs to current society. The proper balance needs to be found.

The laws of physics tell us that for every action there is an equal and opposite reaction, and FDICIA is not immune to this concept. By requiring standards limiting interbank credit exposures, FDICIA could disrupt interbank markets and long-standing banking relationships. This disruption, along with others caused by FDICIA, might contribute to general liquidity problems in the banking system. FDICIA also imposes added restrictions on bank directors and has increased their potential liabilities. These changes may add to the difficulties banks are already experiencing in attracting qualified directors.

With the emphasis on capital, the mandate for regulating internal controls and operating standards, and the increased record-keeping requirements on certain types of loans

--can we be surprised that many banks have retrenched and tightened their credit standards? If the tendency toward micro-management continues, we should expect market distortions to continue. I am hopeful that the current emphasis on re-examining bank regulation will ultimately result in an environment where banks can act prudently, but also be willing and able to take measured risks.

**Condition of Industry**

Recent progress made by the industry to improve capital and earnings suggests that banks may be more capable of increasing their lending activities than in the past several years. Although full-year results are not yet in, available information suggests that 1992 will be the industry's most profitable--not only in dollar terms, but in ROAs as well. Through the first nine months, commercial banks earned $24 billion and should earn more than $30 billion for the year. Strong profits were widespread among banks of all sizes.

Increased earnings, reduced dividends, and record stock sales have also helped strengthen the industry's capital ratios. For the year, equity capital may have increased also by $30 billion, or by 12-13 percent for the year. At the end of September the industry's average risk-based capital ratio was 11.9 percent, well above the minimum 8.0 percent required.

In view of the banking industry's improved financial condition, much has been made of the banks' apparent desire to buy securities, rather than to make loans -- the "credit crunch." Our surveys consistently indicate that this pattern principally reflects weak loan demand, although there may be some supply side effects. As the economy picks up and loan demand improves, a stronger and more liquid banking system should be both able and willing to meet their customers' needs.

**Conclusion**

As implementation of FDICIA moves forward, it is becoming increasingly clear that the industry has been stung with potentially painful legislation. Fortunately, the current environment is favorable for most banks and is providing them an opportunity to improve both their condition and their public image. To turn the tide of further unwanted regulations, banks need to build upon this improvement and demonstrate continued progress. They must also demonstrate that they are willing and able to meet the credit needs of their communities.

In this improved environment, the Congress may be more willing to enact legislation that helps banks--legislation that enables them to compete more effectively and efficiently without undue constraints. In particular, I hope we can see legislation which will allow banks to engage in a broader range of activities, as banks do in many other developed nations. Banks should also be able to branch across state lines in order to take advantage of organizational and technological efficiencies and market changes. The current environment is not one that the authors of the McFadden Act could have envisioned.

The banking industry faces many changes in the coming years, only one of which is the new regulatory environment created by FDICIA. We must be careful going forward not to constrain our banking system so much that it is not responsive to the country's needs. In an increasinlgly international and competitive financial market, we can ill afford to tie the hands of our banks with stifling and constantly changing rules and regulations. The strength of the economy depends on a healthy banking system to finance its growth.

Thank you.