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CONTAINING BANK COSTS: A POLICYMAKER'S PERSPECTIVE
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As we come to the end of a year that could hardly be called "banker-friendly," I am pleased to have been invited to speak to you on the topic of containing costs. While a competitive banker always tries to find ways to save money on the bottom line, bankers know that cost-containment becomes crucial during a period of heightened competition, such as the one the industry is experiencing now. As you well know, banks are being challenged in many markets around the nation, both by other bank institutions and by nonbanks. Nonbanks are succeeding in taking market share away from banks, thanks in part to their being able to provide services that banks are prevented from offering. Compounding matters, the absence of new powers in the recent banking reform legislation continues to make it difficult for banks to broaden their market share.

Although it is not the role of the Federal Reserve to protect the market share of banks, we do recognize that banks render services of social value that nonbanks do not even pretend to provide. Small businesses, for example, rely heavily on bank loans. Likewise, many consumers depend on banks to meet most of their financial service needs. Therefore, we do not want to see the market share of banks fall more than necessary. At the same time, we must ensure that the public perceives banks to be safe and sound institutions. This social goal imposes considerable regulation on banks, which can, if excessive, reduce flexibility and raise costs. The Fed and other regulators must strike a balance between the Scylla of over-regulation that could lead to excessive costs and the Charibdys of under-regulation that could lead to unsafe banking practices and great costs to taxpayers. Fortunately, most bankers understand the long-term benefits of the regulations we must enforce for the betterment of the industry.

Since the other speakers on your program are covering the nuts and bolts, so to speak, of cost containment, I would like to discuss the topic with you from a policymaker's perspective. To begin with, I will emphasize what policymakers have done and can do to help banks keep costs down. Then, I will turn to what banks should do.

The Role of Public Policy in Cost-Containment

First, policymakers should take actions that reduce the unnecessary barriers to mergers while eliminating artificial incentives to merge. The United States has a large number of banks compared with other industrial countries. Two statutory policies have supported this industry structure: restrictive rules on geographic expansion and a deposit insurance system that allowed under-diversified banks to continue in operation. These policies were feasible when banks faced minimal competition from nonbank firms. Indeed, for a long time after World War II, the owner of a bank charter was almost guaranteed a stream of profits provided the managers of the bank were honest and minimally competent. However, competition has increased substantially, as you well know. Honesty and minimal competence are no longer sufficient to guarantee profits. Banks that provide the most value to their customers at the lowest costs should be allowed to expand, while those that cannot cope with the new environment should leave the industry. To achieve this transition and to allow weaker banks to be absorbed by stronger institutions, remaining unnecessary barriers to consolidation, such as restrictions on interstate branching, must be removed.

At the same time, policymakers must not encourage socially costly mergers. In particular, society does not benefit when banks seek to grow merely in order to become too big to fail. Nor is it appropriate for banks to become so strong in their local market that they can take advantage of customers who, for various reasons, cannot go beyond their local area for financial services. I think that the new legislation will substantially reduce the incentive to become large to attain additional deposit insurance coverage. Congress has provided a very strong mandate to the regulatory agencies to close banks before they incur large losses. The new law also restricts deposit insurance to accounts with *de jure* coverage in all but emergency cases. No bank, no matter how large it becomes, can be completely confident that it will be too big to fail after the new legislation takes full effect in 1995.

As a regulatory agency, the Fed must keep in mind that some banking customers, as I just mentioned, are locally constrained, especially small businesses and less wealthy consumers. Antitrust laws require that the Fed look after their interests. This is not to say that we cannot look at the realities of the market place and recognize that some markets cannot support as many banks as they once did. For example, in one case which was subsequently approved, the Federal Reserve Bank of Atlanta recommended approving a merger that left a small Georgia county with only one bank. However, the Fed must continue to scrutinize mergers that would adversely affect customers who have few options by eliminating a viable local competitor.

There are two other areas in which the Fed itself is searching for cost reductions in order to lower the operational costs of banks. By consolidating our automated operations from twelve banks to three, we expect to see the kind of cost-savings that we should be able to pass on to our customers. We are also working on a number of payment systems projects, such as check truncation and an all-electronic automated clearinghouse (ACH), which are designed to cut costs at the Fed and eventually for our banking customers. However, since the Fed is a regulator, it cannot focus exclusively on costs. Its special role has to do with instituting safety measures. In the short run, these do cost money. Two examples are daylight overdraft monitoring and disaster recovery.

What Banks Can Do

While the Fed can create an environment that holds down costs, the ultimate responsibility--even in regulatory matters--rests largely with banks. The Fed could minimize the paperwork and operations expenses of banks by seeking to enforce the lowest-cost method of complying with legislative mandates. However, such a measure becomes necessary only after the fact of a Congressional mandate. In the main, it would be far better--and it would help to keep costs down--if banks and regulators could reach agreement on certain practices rather than having to follow a detailed plan laid out by Congress.

A good example is the Expedited Funds Availability Act of 1987. Although the Fed and some trade associations had been encouraging banks to shorten the periods during which they held checks, Congress finally became impatient with what it deemed a lack of progress. Then, Congress put all banks on a rigorous timetable, even though only a few had been grossly guilty of excessive delays in making deposits available. As you recall, the legislation and associated regulations caused many headaches and great cost for both banks and the Fed during the implementation period.

Similarly, Congress is growing impatient with banks in terms of the results they are achieving under the Community Reinvestment Act (CRA), passed 14 years ago to mitigate the social ills of racial discrimination and a lack of affordable housing. As a result, part of the FIRREA legislation included provisions for much more extensive reporting on loans--and on denials--by race, gender, and income. Clearly, the revisions to the Home Mortgage Disclosure Act add to the amount of paperwork and consequent costs to which banks are subjected. However, if banks do not show more creativity and energy in meeting their CRA requirements, they could be subjected to even more restrictive legislation. As these two examples demonstrate, legislative solutions often create higher costs than industry-evolved approaches would. This phenomenon does not apply only to the banking industry. We can look at the whole array of 1970s environmental goals that could have been achieved more cost-effectively.

Thus, one reason for excessive costs can be traced to overly detailed and specific legislation, which allows for very little latitude in terms of enforcement. The amount of detail seems to be proportionate to the length of time a problem has been allowed to fester. Congress also reacts more strongly when numerous dissatisfied constituents register their complaints. Unfortunately, the banking industry has been affected by these factors in the past, and the situation has not changed appreciably. Credit card rates come to mind immediately as an issue that was ripe for Congressional legislation. It narrowly escaped becoming part of the banking reform bill, even though the Senate approved a credit card cap. Consumers have begun to complain more loudly now that legislators have lent their weight to the issue.

The lesson to be learned here is that bankers must get ahead of the curve in order to preempt Congressional mandates. It is extremely important that banks not wait for proposed legislation to become law and then react negatively to it. This behavior merely reinforces the belief on the part of legislators that banks are somehow "the bad guys" and that Congress must intervene to protect the concerns of society.

In this same regard, bankers must accept that vigorous enforcement of regulations or laws, such as CRA, is in their own best interest. Examiners serve to place constant reminders of the social role that the public and their elected officials expect banks to play in return for the public subsidies they receive. If bankers are uncomfortable with such demands, they should probably consider another line of work.

Another area where banks must learn to understand the importance of acting now to save costs later is risk reduction. By any equation, risk equals cost. The more risks a bank takes, the more likely it will have to cover large costs farther down the road. Risks also raise the costs of funds and make deposit flows less stable. Thus, regulatory policies that reduce risk, like capital requirements, lower costs in the long run. In a sense, reducing risk--whether it be credit risk or interest-rate risk, for example--serves as a preemptive strike for banks. Rather than waiting until regulators discover problems related to risk, which can lead to penalties, banks should find and defend against such unnecessary costs.

Finally, any sensible banker should realize that it makes sense to advocate regulations and proposals that promote safety and soundness. The alternative is to take the chance that you may eventually pay to clean up disasters left by your competitors. Deposit insurance has become more costly this year, and there is a possibility the FDIC may raise the rates yet again next year.

Conclusion

In conclusion, there are many ways to reduce costs in the banking industry, and you are learning about a good deal of them at this conference. However, another kind of policy that can substantially reduce costs over time has to do not so much with finding an outsource for data processing or streamlining back office operations but with solving problems in the industry before lawmakers feel impelled by popular outcries to act. It is never as easy to calculate the costs saved from preemptive actions, but perhaps that is their true beauty. You do not have to add up the costs because you will not have to pay them.

Naturally, I am aware of the feeling in the private sector that any sort of regulation or policy aimed at reducing risk raises costs--period. While I will certainly admit that these policies can raise costs in the short term, I think even the most adamant libertarian would agree that reducing risk now can lower costs over the long haul. Our job as regulators is to educate bankers as to the benefits of reducing risk. In addition, if bankers drag their feet over such issues as credit card rates and loan discrimination, Congress is sure to take up the cause. As we have seen time and again, legislative answers are more expensive than industry answers.

I believe the banking industry attracts the kind of people who are capable of dealing with a wide array of difficult problems. Never have bankers been able to put their intelligence and resourcefulness to such good use as now. Whether the issues be cost-containment or risk-reduction or CRA-compliance, I believe the bankers who survive the 1990s will be well-prepared to compete with any kind of bank or nonbank--and survive.