

# ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

## A Market-Based Approach to Regulatory Reform

by Jerry L. Jordan

**R**egulatory requirements and prohibitions impose significant, although sometimes unintended, taxes on the business of banking. As with all business taxes, the true burden is shared jointly by investors in the form of reduced market valuations of their investment, by employees in the form of lower real wages, and by customers — in this case, in the form of higher interest paid on loans and lower interest received on savings.

Whatever natural comparative advantage depository institutions have in delivering intermediary services is diminished under the weight of these taxes, and businesses and households suffer a reduced menu of financial services. Indeed, the entire economy is harmed to the extent that regulation reduces the efficiency of the financial system and therefore the real growth potential of the economy. Even when regulation is appropriate, its form may matter a great deal.

This *Economic Commentary* outlines a proposal to modify the current regulatory system, with little or no new legislation. This proposal represents an important move in the direction of supplanting and complementing official regulation with market-based regulatory discipline, thereby making greater use of market forces to achieve legitimate regulatory goals (such as the safety and soundness of the financial system) while reducing compliance costs. Harnessing market forces for regulatory purposes will reduce costs because markets are much more efficient than

regulators in successfully modifying banks' behavior.

This modest program for regulatory reform can be readily implemented without any material changes to existing law. Like the more sweeping proposals for reform that have been offered of late, it provides incentives for every bank to become better managed and better capitalized.<sup>1</sup> It does so by creating a process for reducing the cost of complying with bank regulation both directly, because well-managed and well-capitalized banks would pay lower deposit insurance premiums and receive preferential regulatory treatment, and indirectly, because the need for regulation would be reduced by a decline in the risk to the Bank Insurance Fund and to taxpayers. Unlike other market-based reform proposals, the plan does not rely on statutory reductions in deposit insurance coverage to provide banks with incentives to increase their capital and to limit loss exposure. It is also not an alternative to fundamental reforms to the financial safety net and bank regulation. Instead, the plan represents an intermediate step toward the implementation of a true market-based system of bank regulation that might be set in force immediately.

Within that limited scope, this proposal will move the bank regulatory system closer to the Securities and Exchange Commission's (SEC) information and disclosure approach to supervision, which I believe is more efficient than

**Compliance with current regulatory requirements in the banking industry entails significant costs that reduce the efficiency of the financial system and thus the real growth potential of the economy at large. In a recent speech, Federal Reserve Bank of Cleveland President Jerry L. Jordan outlined a four-point program to refocus bank regulation to a market-based system that would result in improved bank safety, soundness, and stability, with less dependence on the federal financial safety net.**

the permission, denial, and directive approach to regulation that is now the norm in banking.

### ■ The High Cost of Bank Regulation

Complying with regulatory requirements and prohibitions entails both explicit and implicit costs. Explicit costs include the resources used to comply with the regulations, such as hiring additional employees to process associated paperwork. The implicit costs imposed by regulatory prohibitions include the forgone opportunities from diverting resources into less efficient activities. Both of these regulatory costs can be significant, but are often overlooked in the heat of concern about bank safety. Indeed, it sometimes appears that there is now zero tolerance for losses to the Bank Insurance Fund, rather than a sense that the costs of in-

curing these losses should be weighed against those of avoiding them.

The costs of regulation are extremely difficult to estimate. Nevertheless, various studies have estimated that the explicit costs of regulatory requirements range from 6 to 14 percent of commercial banks' non-interest expense.<sup>2</sup> Banks' non-interest expense was \$130.9 billion in 1992, suggesting that their regulatory compliance cost in that year was between \$7.9 billion and \$18.3 billion. That compares with industry earnings in 1992 of \$32.2 billion.<sup>3</sup>

However, these estimated costs of regulatory compliance exclude four important categories of additional costs: 1) the opportunity costs of holding excessive non-interest-bearing reserves, 2) the costs of the additional requirements now mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), 3) the forgone profits and efficiencies due to prohibitions on activities and locations, and 4) the opportunity costs associated with treating banks as vehicles for achieving social/political goals.

Looking first at reserve requirements, an opportunity cost is associated with holding excessive non-interest-bearing reserves in Federal Reserve Banks. Reserve requirements are, in effect, a tax that hampers banks from competing successfully with providers of loans and deposit-competing assets that are not required to hold idle reserve balances.

Second, the additional requirements of FDICIA will add to the explicit cost of regulatory compliance. That addition is likely to be substantial, considering the 60 or so working groups at the regulatory agencies that have prepared or are preparing regulations to implement this legislation, and the costs of complying with some regulations already issued.

Third, there are costs to banks, and to the economy at large, of prohibiting banks from entering certain activities and locations. Those implicit costs are hard to measure, and while no estimates are available, the tally is likely to be

## DIFFERENT FORMS OF OFFICIAL BANK REGULATION

Banks are subjected to an array of regulations intended to achieve a variety of purposes. For example, the Internal Revenue Service requires reports on interest paid to and received from bank customers to facilitate and encourage compliance with tax laws; the Treasury Department requires reports of large currency transactions to help detect illegal activities; and agencies that provide government guarantees on loans require special documentation for those loans to protect the government's interests. Some regulations require banks to inform customers of bank practices, some are intended to protect mortgage applicants and other borrowers, and some seek to foster bank safety and soundness.

The broad array of regulations can be divided into four categories: 1) those intended to provide the government with some information about its citizens; 2) those intended to lower the costs of information to depository institutions' customers; 3) those intended to achieve some social/political goals; and 4) those intended to foster safety and soundness so as to encourage maximum long-run sustainable growth. This proposal concerns only that portion of bank regulation intended to foster safety and soundness.

substantial. When banks are prohibited from expanding into specific locations, their balance sheets tend to have less geographic and industry diversification, which reduces their soundness and profitability. Similarly, when they are not allowed to conduct certain activities, product diversification suffers, leading to the same loss in soundness and profitability.

Regulatory prohibitions that restrict banks from entering certain activities or geographic areas thus might diminish the degree of competition in those products and areas, reducing efficiency. However, the natural competitive response to the existence of abnormal profits suggests that other financial firms will enter those activities and serve those areas, so it is possible that substituting nonbanks for banks would reduce or offset at least some of the efficiency loss. On the other hand, efficiency suffers when banks cannot take advantage of opportunities arising from the production of related products.

The existence of a subsidy to banking in the form of the federal safety net has led some to demand that banks should become instruments for achieving political and social goals.<sup>4</sup> Banks have even been likened to persons on public assis-

tance — as long as they are receiving the subsidy implicit in the federal safety net, they must do what government tells them to do.<sup>5</sup> A variant of this view is that banks should be treated like public utilities.<sup>6</sup>

Consequently, some people see banks as a vehicle for gaining access to financial resources through the political process rather than through competition for funds based on the merit of the investment. One example is the call for a national investment policy that was heard a few years ago. Another is the efforts of consumer-oriented individuals or groups, using leverage provided by the Community Reinvestment Act (CRA), to reach agreements with banks to make loans or investments in their favor. Inevitably, such efforts result in a less efficient allocation of scarce resources. The morally valid objective of the CRA — to improve the flow of credit to all neighborhoods in a community — can be impeded when the requirements for complying with the Act become an instrument for seeking an unintended resource redistribution.

### ■ A Four-Point Plan for Regulatory Reform

Large cost, per se, does not prove that regulation is unwise. Clearly, as long as

bank deposits are protected by federal insurance, regulation to control taxpayers' exposure to loss is necessary. Because compliance with regulation is so costly, however, we clearly need to determine if the benefits exceed the costs. Even if we maintain the current regulatory delivery system and its benefits, some reforms may be needed to increase the efficiency of regulation and thus reduce its costs.<sup>7</sup> There are several ways market forces can be used in this regard while increasing the degree of success in achieving the twin goals of regulation—promoting the stability of the financial system and minimizing the cost of the financial safety net. Harnessing market forces to reach these goals is the cornerstone of my reform proposal.

To some people, the concept of market forces regulating an industry sounds like an oxymoron. Doesn't regulation have to be carried out by a government agency? Indeed not. Market forces are overwhelmingly powerful and efficient regulators.

In the most extreme form of a market-regulated banking system, the role of the government would be limited to collecting and disseminating information and to enforcing property rights by resolving contractual disputes. The marketplace would determine the structure and scope of financial intermediaries' activities, and the risks of those activities would be borne directly by the private sector; there would be no remaining vestiges of the taxpayer-provided financial safety net. More-limited reforms could justifiably retain a limited amount of deposit insurance coverage (a maximum of \$10,000 per depositor) and SEC-style regulation.

Such sweeping changes, although desirable on the grounds of both efficiency and long-run financial stability, would have significant transitional or switching costs. Taking a longer-run perspective, my proposal for regulatory reform should be viewed as an intermediate step to facilitate the implementation of full-scale market discipline on banking by providing for an orderly transition period and minimizing the switching costs.<sup>8</sup>

To reduce the need to rely on official regulation, I propose the following four-point plan for regulatory reform: 1) greater market discipline through increasing the disclosure of information; 2) more private risk-bearing by increasing the benefits and reducing the regulatory costs of holding more capital; 3) removal of some of the regulatory obstacles to industry consolidation by reducing bureaucratic time delays associated with intra-industry acquisitions and branch location decisions; and 4) reduction of some of the regulatory-based incentives for financial firms to adopt otherwise inefficient organizational structures.

#### ■ Improved Information

The first, and most important, reform is to provide the public with improved information about the condition of individual banks. The advancement in the quality and timeliness of information would come in two forms. First would be the adoption of current, or market-value, accounting systems for valuing bank assets and liabilities. Second would be the mandatory quarterly publication of regulatory risk ratings for each bank, including the bank's risk-based deposit insurance assessment, its prompt corrective action classification, and its latest examination rating.

The adoption of market-value accounting for assessing bank condition would give market participants a more accurate picture of a depository institution's health than do the historically based accounting systems now used by regulators. Public disclosure of regulatory risk ratings would give the market timely information on both a bank's asset quality and its solvency. Moreover, disclosure would hold regulators accountable for producing high-quality audits of financial firms. Although banks are not prohibited by statute from disclosing examination ratings, regulators do have the authority to prevent them from doing so. Requiring such disclosures would make the eventual curtailment of deposit insurance more practical, because depositors would have available the information necessary to protect themselves.

#### ■ Increased Reliance on Capital

A second reform is to provide incentives for banks to increase their capital. For example, banks that have top examination ratings and that are especially well capitalized (exceeding regulators' current threshold for well-capitalized banks by some 20 to 30 percent) could be given some relief from the frequency and intensity of examinations that are intended to enhance their safety and soundness.<sup>9</sup> Indeed, for sufficiently well-capitalized banks, we might ask why there should be any safety-and-soundness-oriented regulation.<sup>10</sup>

We can reduce the burden of the portion of the examination process that determines asset quality by placing greater reliance on those banks' own internal systems of loan quality review and by reporting, after supervisory verification, on their adequacy. That would mean fewer officer hours required to assist examiners in reviewing loan documentation. Similarly, in the case of banks that have strong internal controls and audit systems, there would be less need for examiners to review for compliance with various laws and regulations. Moreover, banks that are especially well capitalized and that have in place systems of interest-rate risk measurement that are already under examiners' review could be exempted from having to establish and use the standardized system currently being devised by the regulatory agencies.<sup>11</sup> These approaches would reward good management and strong capitalization, but with no deleterious consequences for safety and soundness. Still another change would be to reduce the frequency of examination of such banks to greater than 12-month intervals—although this would require legislation, as FDICIA now mandates annual examinations.

The opportunity for gaining a reduction in regulatory compliance costs would give banks that are less well-capitalized an incentive to improve their capital-to-assets ratios so as to qualify for this preferential treatment. Of course, this incentive would increase the need for accounting measures that accurately represent a bank's true situation. For banks that

do qualify, the reduction in regulatory costs would increase their return on assets and equity, lower their cost of capital, and enable them to expand and thereby pressure other banks to become better capitalized and better managed.

#### ■ **Reduced Regulatory Obstacles to Consolidation**

The third point of this proposal would remove regulatory obstacles and reduce transaction costs associated with the ongoing consolidation of the banking industry. In other words, for strong depository institutions, the regulatory costs associated with entering new markets would be lessened, thereby encouraging the removal of poorly managed banks from the financial system through both acquisition and increased competition in local banking markets. This reform would largely be accomplished by establishing a streamlined regulatory procedure for certain bank mergers and acquisitions or for nonbanking activity expansions involving especially well-capitalized, well-run organizations. If such an organization sought to acquire another bank or engage in a nonbanking activity that the Federal Reserve Board had already determined to be permissible, it would be required merely to submit a letter notifying the appropriate supervising agency of its intentions and the nature of the activity.

To make this procedure operational, the regulatory agencies would publish a list of the qualifying criteria for the applicant and for the transaction or activity expansion. For example, in the case of a bank holding company acquisition of a bank, the applicant would necessarily be well capitalized, all of its banks would be rated at least satisfactory for CRA performance, and the transaction could not raise any legal or competitive issues. The notice would briefly describe the transaction and certify that the criteria set forth by the supervising agencies were satisfied.

To implement this concept, some changes would be needed regarding the way in which regulatory agencies deal with CRA comments and objections from community groups. Assessments

of banks' CRA performance could be greatly improved by soliciting comments from community groups as part of the regular examination process and not solely in the applications process. The agencies could provide public notice of scheduled CRA examinations and give interested parties an opportunity to submit comments in writing or to request a meeting with the examiners. If the banking organization received a good CRA rating and subsequently filed an application, any protest about that application would be considered substantive only if the commenting party could show good cause why the comments were not submitted during the regular examination process or why the commenter believed that an issue raised previously had not been resolved.

#### ■ **Improving the Efficiency of Financial Service Delivery Systems**

The fourth plank in the proposal is to reduce regulatory incentives for banks to adopt inefficient organizational forms. This reform would provide relief from regulation and its attendant costs to especially well-capitalized bank holding companies that have top examination ratings and that are willing to give the Federal Reserve explicit, legally binding commitments to be a source of strength to their banks. One way to do this would be to reduce the examination of their subsidiary banks, at least to the extent that the holding company's separate capital could support the subsidiaries.<sup>12</sup> Capital requirements, or requirements for financial reporting and review and loan policy and supervision, could be satisfied at the holding company level instead of being examined at each individual bank.

Similarly, with the same binding source-of-strength commitment, restrictions on interbank liabilities and determination of deposit insurance premium rates could be enacted at the holding company level rather than at the subsidiary bank level. In addition, bank supervisors could expand the list of nonbanking activities permissible for the nonbank subsidiaries of bank holding companies that have given source-of-strength commitments. Finally, supervisory agencies could give such subsidiaries more leeway

to engage in securities underwriting and other limited activities by raising to 49 percent (from the current 10 percent) the limit on the share of a separately capitalized subsidiary's revenue that could be derived from that activity without being considered in violation of the prohibition against being "principally engaged" in that activity.<sup>13</sup>

#### ■ **Conclusion**

Adoption of the four proposals I have outlined here would reduce the costs of regulatory compliance while providing positive incentives for banking companies to increase their safety and soundness. That would improve earnings, enable banks to attract capital more easily, and thereby enhance their safety, soundness, and ability to expand. As a result, it would also pressure other banks to become safer and sounder in order to increase their own competitiveness.

The regulatory relief from these proposals might be larger than it initially seems, because as other banking companies respond to the incentives and become highly capitalized, they too would reap the benefits. An additional advantage of these proposals is that they would require less regulatory scrutiny to be given to banking companies that need it less, allowing some regulatory resources to be redirected to giving closer attention to banking companies that need it more.

Finally, through increased disclosure of information and by employing the other incentives for increased levels of private capital, these reforms would help to wean the depository institutions industry from its dependence on the federal financial safety net. This, in turn, would increase the industry's stability, as bank funding and investment decisions would then more fully incorporate the risk-return trade-off, thus reducing the transition costs associated with more fundamental safety net reforms.

## ■ Footnotes

1. The cornerstone of most market-based reforms is increased exposure of bank stakeholders to risk. A dramatic reduction in the size and scope of the federal financial safety net (which consists of federal deposit insurance, Federal Reserve discount window advances, and Federal Reserve payments system guarantees) is the most efficient and equitable way to accomplish this. See James B. Thomson, "Economic Principles and Deposit-Insurance Reform," Federal Reserve Bank of Cleveland, *Economic Commentary*, May 15, 1989; and "A Market-Based Approach to Reforming Bank Regulation and Federal Deposit Insurance," *Research in Financial Services: Public and Private Policy*, vol. 4 (1992), pp. 93-109.
2. See Federal Financial Institutions Examination Council, *Study on Regulatory Burden*, Washington, D.C.: December 17, 1992, p. C-15.
3. Bank earnings and non-interest expense data are from the Federal Deposit Insurance Corporation, *The FDIC Quarterly Banking Profile*, Washington, D.C.: Fourth Quarter 1992.
4. The safety net comprises federal deposit insurance, access to the Federal Reserve discount window, and Federal Reserve provision of intraday credit through its operation of the nation's payments system.
5. Representative Henry B. Gonzalez, chairman of the House Banking Committee, remarked, "When you're on relief, there are lots of rules. Just ask the poor folks on food stamps." Quoted in Barbara A. Rehm, "GAO Chief Says FDIC May Have to Divert Funds for S&L Cleanup," *American Banker*, July 1, 1992, p. 1.
6. For example, Wojnilower asserts that "Both the payments and the credit system have been and should continue to be regarded and treated as public utilities. Banks should not be required, encouraged, or even allowed to withdraw from lending and maturity transformations, any more than an electric utility would be permitted to withdraw service from part or all of its territory. For banks, as for other utilities, we should limit competitive access, assure adequate but capped returns, and restrict ventures in unrelated fields." See Albert M. Wojnilower, "Not a Blown Fuse: Comments on 'Perspectives on the Credit Slowdown,' by Richard Cantor and John Wenninger," presented at the Federal Reserve Bank of New York Colloquium: The Role of the Credit Crunch in the Recent Recession, February 12, 1993, pp. 4-5.
7. Even without cost-benefit analysis, which is beyond the scope of this paper, it is certain that lowering the cost of achieving regulatory goals is clearly desirable. For a list of suggestions for reducing regulatory compliance costs, see the Federal Financial Institutions Examination Council, *Study on Regulatory Burden*, Washington, D.C.: December 17, 1992.
8. For a discussion of market-based banking reforms, see W. Lee Hoskins, "Reforming the Banking and Thrift Industries: Assessing Regulation and Risk," paper presented at the 1989 Frank M. Engle Lecture in Economic Security, The American College, Bryn Mawr, Pennsylvania, May 22, 1989; James B. Thomson, "Using Market Incentives to Reform Bank Regulation and Federal Deposit Insurance," Federal Reserve Bank of Cleveland, *Economic Review*, vol. 26, no. 1 (1990 Quarter 1), pp. 28-40; and James B. Thomson and Walker F. Todd, "Rethinking and Living with the Limits of Bank Regulation," *Cato Journal*, vol. 9, no. 3 (Winter 1990), pp. 579-600.
9. Regulators consider a banking company to be well capitalized if it meets the following criteria: 1) Total risk-based capital ratio is 10 percent or above; 2) Tier 1 risk-based capital ratio is 6 percent or above; 3) Tier 1 leverage capital ratio is 5 percent or above; and 4) the institution is "not subject to any ... capital directive ... to meet and maintain a specific capital level for any capital measure." See "Prompt Corrective Action," *Federal Register*, vol. 57, no. 189 (Tuesday, September 29, 1992), pp. 44885-44909. For definitions of these ratios, see Board of Governors of the Federal Reserve System, "Capital Adequacy Guidelines," March 15, 1989.
10. Recently, the four federal regulators of banks and thrifts announced that they "... are working on the details of a new program to help ensure that regulatory policies and practices do not needlessly stand in the way of lending." One part of that program would logically be part of reform two in this paper: "Strong and well-managed banks and thrifts will be permitted to make and carry a basket of loans [to small businesses] with minimal documentation requirements, consistent with applicable law," and with a limit "... on the aggregate of such loans a bank may make." See Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, and Office of Thrift Supervision, "Interagency Policy Statement on Credit Availability," Washington, D.C.: March 10, 1993, pp. 1-2.
11. See Stephen F. LeRoy, "A Better Way to Monitor Rate Risk," *American Banker*, December 30, 1992, p. 4.
12. Extended examination frequency and consolidated examination at the holding company level in lieu of full-scope examination at the subsidiary level would require some minor changes in legislation.
13. The four federal regulators of banks and thrifts have agreed that, to reduce the burden of the examination process, they will "... establish procedures to centralize and streamline examination in multibank organizations," but they give no details on how that will be accomplished. See Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, and Office of Thrift Supervision, "Interagency Policy Statement on Credit Availability," Washington, D.C.: March 10, 1993, p. 5.

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For a more thorough discussion of this proposal, see "A Market Approach to Banking Regulation," address delivered to the CATO Institute Eleventh Annual Monetary Conference on Financial Deregulation in a Global Economy, March 18-19, 1993.

## Conference Examines Possible Effects of NAFTA on Economy of Great Lakes Region

Will the proposed North American Free Trade Agreement (NAFTA) help or harm the economy of the Great Lakes region? That was the question explored in a conference held in March 1993, jointly sponsored by the Federal Reserve Bank of Cleveland and the Fraser Institute of Vancouver, Canada. A printed summary of the proceedings, *Charting a Course under Free Trade*, will be available in late June from the Federal Reserve Bank of Cleveland.

The daylong conference brought together panels of experts to examine the implications of NAFTA from a variety of perspectives. Topics for discussion included the economic impact of liberalized trade in the United States and Canada, the challenges and opportunities of having Mexico as a partner in free trade, and strategies that companies, labor organizations, and communities have used in the past to benefit from free trade.

Among the conference's speakers were Joseph Gorman, chairman and chief executive officer of TRW, Inc.; Manuel Suárez-Mier, minister of economic affairs in the Mexican embassy to the United States; Sidney Weintraub, Deak Rusk Professor of International Relations at the LBJ School of Public Affairs of the University of Texas; Michael Walker, executive director of the Fraser Institute; Kenneth Coss, international president of the United Rubber Workers; and Andrew Rudnick, president and chief executive officer of the Greater Buffalo Development Foundation and the Greater Buffalo Chamber of Commerce.

Speakers generally agreed that, in the long run, the economy of the Great Lakes region will benefit from the freer trade NAFTA would bring about. The region would initially experience job losses in some sectors, but these would be more

than offset by jobs created from increased exports to Mexico. Any changes in employment or output resulting from NAFTA, however, are likely to be modest, amounting to less than 1 percent of the country's gross domestic product.

At the same time, speakers agreed that government and employers have an obligation to help workers displaced as a result of the agreement. Many of the mechanisms for doing so already exist, speakers said, but could be made to work more efficiently.

Single copies of *Charting a Course under Free Trade* will be available free of charge beginning June 30 from the Public Affairs and Bank Relations Department of the Federal Reserve Bank of Cleveland at 1-800-543-3489.

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