A Market Approach to Banking Regulation

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I. INTRODUCTION

The cost of complying with regulatory requirements and prohibitions is a major problem for banking today. Regulations imposed with even the best of intentions entail substantial costs, many of which are unintended. The costs of complying with regulation constitute a tax on the business of banking. As with all taxes on business, the true burden is shared 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. Also, whatever natural comparative advantage depository institutions have in delivering intermediary services is diminished, 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.

Today I will propose ways to modify the current regulatory system, with little or no new legislation, that make greater use of market forces to achieve legitimate regulatory goals while reducing compliance costs.[1] Harnessing market forces for regulatory purposes will reduce costs because markets are much more efficient at modifying banks' behavior than regulators could ever hope to be.

These proposals provide incentives for every bank to become a member of a group of banks that are especially well managed and well capitalized. This approach creates a process

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[1]Legislation is another approach through which the costs of regulatory compliance might be reduced. Some bills seeking to reduce regulatory burden were introduced into Congress early in 1993. See U.S. Congress (1993) H.R. 59, H.R. 269, and S. 265.

for reducing the cost of complying with bank regulation both directly, as banks earn their way into the "quality club" of financial intermediaries, and indirectly, as the need for regulation is reduced by a decline in the risk to the Bank Insurance Fund and taxpayers.

Banks are subjected to a wide 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 customers of depository institutions; (3) those intended to achieve some social/political goals; and (4) those intended to facilitate maximum long-run sustainable growth. My proposals concern only that portion of bank regulation that is intended to foster safety and soundness so as to achieve the highest rate of growth that is sustainable in the long run.

Within that limited scope, my proposals 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 the permission, denial, and instruction approach to regulation that is the norm in banking. These two regulatory systems are, in essence, competing with each other through the firms that they affect -- banks on the one hand and nonbank financial services firms on the other. If the bank regulatory approach burdens banks more than their competitors are burdened by the SEC approach, after taking into account the benefits that banks get from the federal safety net, banks will be at a cost disadvantage in offering financial services to customers. Firms not subject to bank regulation will use their cost advantage to entice customers away from banks. Thus, bank regulation generally will not prevent customers from obtaining financial services, but will increase the likelihood that those services will be obtained from nonbank financial services firms. The proliferation of alternatives to banks in recent years suggests the SEC approach is superior and that a shift of sources is occurring. The increasing availability of bank-like services from finance companies, mutual funds, brokerage houses and insurance companies suggests that the regulated depository institutions are holding on to a shrinking share of the intermediary services market. Economists don't lament sourcing shifts caused by differences in the efficiencies of suppliers, but shifts that result from government-imposed handicaps waste scarce resources. Therefore, it would be in the public interest if more efficient regulatory methods were adopted to achieve the legitimate aims of bank regulation, while relying on natural comparative advantage to determine the outcome among equally-supervised competitors.

II. ORIGINS OF THE REGULATORY PROBLEM

In large measure, the origin of excessive regulatory costs in banking lies in the early 1930s, when more than one-third of U.S. commercial banks failed. Congress responded in

1933 by creating federal deposit insurance for banks and thrifts and by prohibiting them from engaging in certain activities that Congress believed were too risky for insured depositories. Federal deposit insurance was an integral part of the Glass-Steagall Act. Originally, federal deposit insurance covered only $2,500 per account, but by 1980 the limit was $100,000, nearly five times the original amount, after adjustment for inflation. This may have been done with the best of intentions, but it has had major unintended negative consequences.

Lest we use our 20-20 hindsight to be too critical of the Congress of 60 years ago or even 13 years ago, it is well to remember that some well-respected scholars formerly saw great merit in a basic level of deposit insurance. Friedman and Schwartz (1963), for example, describe federal deposit insurance as "the structural change most conducive to monetary stability" (p. 434), and "a form of insurance that tends to reduce the contingency insured against"(p. 440).[2] Moreover, part of the adverse outcome of the deposit insurance experiment was a result of forbearance in administering regulations, not of regulation, per se.

The most visible negative consequence was the recent massive losses suffered by the Federal Savings and Loan Insurance Corporation in the savings and loan (S&L) debacle. In the late 1970s, when inflation drove deposit interest rates to very high levels, many S&Ls suffered major losses because most of their assets were low-fixed-rate, long-term mortgages that were funded by short-term deposits on which they had to pay higher and higher rates.

As continuing losses drained their capital, managers of many S&Ls that had become de facto insolvent tried to rescue their institutions by making new, very risky, higher-rate

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[2]Schwartz has since revised her views on the stabilizing effect of deposit insurance. See Schwartz (1988).

loans that held the possibility of being very profitable. They were able to finance these risky, high-rate loans with relatively low-cost deposits because deposit insurance removed from depositors any incentive to be informed or concerned about the riskiness of the loans that their deposits were funding.[3]

Some managers were successful in saving their institutions with this strategy, but a large number of institutions suffered further losses from risky loans that went sour. In the end, about one-third of the asset values in the thrift industry disappeared, losses in failed thrifts exceeded the resources of the Federal Savings and Loan Insurance Corporation, and general tax revenues were used to honor depositors' claims.

In effect, establishing deposit insurance at high levels and forbearing on capital-deficient firms created a moral hazard that turned out to be very costly to the insurance funds and the taxpayers.[4] Congress then sought to protect the taxpayer by reducing the moral hazard in banking by more stringent safety and soundness regulation of banks and by circumscribing the latitude of the regulators to engage in forbearance with troubled depositories. The most significant recent legislation of this type for commercial banks was the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

Thus, the FDICIA was primarily a reaction to the huge losses in the FSLIC and the perceived impending insolvency of the Bank Insurance Fund. Congress was determined to do something to minimize the exposure of the Bank Insurance Fund.

What is missing in bank supervision and regulation is a sufficient distinction between

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[3]See Kane (1989).

[4]See Woodward (1992) and Thomson (1993).

well-capitalized, well-managed institutions and marginally-capitalized, inadequately-managed institutions. New powers and exemptions from some regulations can be granted to the strongest institutions while still achieving the aims of legislation. An appropriate distinction would take a triage approach, as follows:

1. Banks that are terminally ill should be closed promptly lest they needlessly absorb scarce examiner and deposit insurance fund resources. The FDICIA took important steps in this direction with its prompt corrective action requirement that closes banks whose capital-to-assets ratio falls below 2 percent.
2. Banks that clearly are healthy should be exempted from much "safety and soundness" regulation, lest they needlessly absorb scarce examiner resources, and waste their own resources complying with regulations that are inappropriate for banks in their condition.
3. The sick, but potentially viable, banks are the ones where supervisory efforts should be focused, to try to restore them to health and to prevent them from sliding into the terminally ill category.

Unfortunately, current supervisory policy has regulators treating healthy banks essentially the same as banks that are sick, but potentially viable.

III. THE HIGH COST OF BANK REGULATION

The cost of compliance with regulatory requirements includes both the explicit costs of meeting regulatory requirements, and the implicit costs imposed by regulatory prohibitions.

Both costs are large, 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 losses should be weighed against the costs of avoiding losses.

Various studies have estimated that the costs of regulatory requirements range from 6% to 14% of commercial banks' non-interest expense.[5] 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.[6]

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 FDICIA; (3) the costs to the banks and the economy of foregoing the profits and efficiencies that would have resulted if banks were not prohibited from various activities and locations; and (4) the costs of treating banks as vehicles for achieving social/political goals.

Looking first at reserve requirements, there is an opportunity cost to holding excessive non-interest-bearing reserves in Federal Reserve Banks. Any calculation of that opportunity cost must consider that banks use their reserve balances for clearing purposes and, in the absence of reserve requirements, would incur other costs of clearing. However, the

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[5] See Federal Financial Institutions Examination Council (1992), p. C-15.

[6] Bank earnings and non-interest expense data are from Federal Deposit Insurance Corporation (1992).

opportunity cost of required reserves is not the relevant concern. The appropriate concern is the wedge that reserve requirements create at the margin, hampering banks in their competition with providers of loans and deposit-competing assets that are not required to hold idle reserve balances.

Second, the additional requirements of the FDICIA will add to the 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 the FDICIA, and the costs of complying with some regulations already issued.

Third, there are costs to banks and to the economy of prohibiting banks from entering certain activities and locations. Those costs are hard to measure, and while no estimates of such costs are available, they, too, are likely to be substantial. When banks are prohibited from entering certain locations, their balance sheets tend to have less geographic and industry diversification, which reduces their soundness and their profitability. Similarly, when banks are prohibited from entering certain activities, banks have less product diversification, which also reduces their soundness and their profitability.

Those prohibitions impose costs on the economy. Restricting banks from entering certain activities and certain geographic areas might reduce the degree of competition in those products and areas, reducing efficiency. However, efficient markets theory suggests that other financial firms will enter those activities and serve those areas, so it is possible that substituting non-banks for banks would minimize the loss of efficiency. On the other hand, if some bank economies of scope are lost because of prohibitions, the efficiency loss is increased.

There is a cost to the public of providing to depository institutions the subsidy implicit in the federal safety net. The safety net is comprised of federal deposit insurance, access to the Federal Reserve discount window, and Federal Reserve provision of intraday credit through its operation of the nation's payment system.

The subsidy to banks embodied in the federal safety net, and the consequent web of regulations, cause some people to think of banks differently than they think of most other private firms. Banks have even been likened to persons on welfare -- as long as they are receiving the subsidy implicit in the federal safety net, they must do what government tells them to do. Representative Henry B. Gonzalez, Chairman of the House Banking Committee, has said that "When you're on relief, there are lots of rules. Just ask the poor folks on food stamps."[7] A variant of this view is that banks should be treated as public utilities.[8]

Consequently, some people want to treat the banking system as an instrument for achieving social and political goals. They see banks as a vehicle for getting 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),

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[7] Quoted by Rehm (1992), p. 14.

[8] For example, Wojnilower (1993) asserts (pp.4-5) 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 other utilities, we should limit competitive access, assure adequate but capped returns, and restrict ventures in unrelated fields."

to reach agreements with banks to make loans or investments favored by those groups. Sometimes such efforts result in a less-efficient allocation of scarce resources. The morally valid objective of the CRA -- to improve the flow of credits to all neighborhoods in a community -- can be impeded when the requirements for complying with the act become an instrument for seeking resource redistribution that was not intended by the act.

IV. REGULATORY OBJECTIVES COULD BE ACHIEVED MORE EFFICIENTLY USING MARKET FORCES

Large cost, per se, doesn't prove that regulation is unwise. Clearly, so long as bank deposits are protected by federal insurance, regulation to control taxpayer exposure to loss is necessary. However, the large cost of compliance with bank regulation does strengthen the argument for analysis to determine if the benefits of regulation exceed the cost.

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. The Federal Financial Institutions Examination Council (FFIEC) ***Study on Regulatory Burden*** (1992) generated a list of suggestions for reducing regulatory compliance costs, many of which I support. Beyond these recommendations, however, there are several ways that market forces can be used to reduce the cost of bank regulation or increase the degree to which some of the goals of regulation are achieved.

One of the major purposes of regulation is the promotion of bank safety and soundness, in order to protect customers, the Bank Insurance Fund, and taxpayers from bank failure. Most of my suggestions are about ways to use market forces to reduce the cost of pursuing that goal and to increase the degree to which that goal is achieved. Adopting these suggestions will foster a stronger and more efficient banking and payments system, which is consistent with the overall goal of maximizing sustainable, long-run economic growth.

Perhaps the broadest approach to limiting the risk to the Bank Insurance Fund while freeing banking organizations to compete freely in all facets of the financial services industry would be to reorganize the banking industry along the lines of a narrow bank - broad bank dichotomy. That proposal envisions the creation of a narrow, or core, bank that accepts transaction deposits, invests only in short-maturity, highly-liquid assets, offers a narrow range of services to its customers, has deposit insurance, and is supervised by an organization such as a Federal Reserve Bank.[9] The narrow bank could not engage in riskier lending or offer other financial services, which instead could be offered by separately incorporated, non-federally insured subsidiaries within the same financial services holding company. The intention is that these other subsidiaries would have no benefit from and would pose no risk to the Bank Insurance Fund, and therefore would not need to be subject to regulation by banking authorities. This approach would be a substantial departure from the present banking system and would require major new legislation, so I won't consider it further in my remarks today.

If we assume that there will be no such major change in the powers and structure of banking organizations, then the broadest approach to using market forces to achieve the goals of regulation would be to eliminate or greatly reduce deposit insurance, or introduce coinsurance, while taking steps to expand the amount of information about banks that is

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[9]Proponents of this approach and its variations include Friedman (1959) pp. 65-75, Tobin (1987), Litan (1987), Bryan (1991). Phillips (1992) discusses the influence of this proposal on banking legislation in the 1930s. Critics include Ely (1991) and Simonson (1991).

available to depositors and creditors. More depositors would then take an interest in the soundness of banks, and banks would have to demonstrate their soundness to attract deposits. This proposal has been discussed at length elsewhere, so I won't elaborate on it here.[10] Even though this approach makes good economic sense, there are substantial political barriers to its adoption. Therefore, for the purposes of this paper, something like the present deposit insurance system is reluctantly taken as a given.

There is one action, however, that could be taken right now that would make reduction or removal of deposit insurance more feasible in the future. That action would be to implement a proposal, which will be detailed below, for providing the public with additional information about the condition of individual banks. This would overcome one of the political objections to the removal of deposit insurance, namely, that depositors don't have sufficient information to make decisions about the soundness of the banks in which they make deposits.

Risk-based deposit insurance premiums are a move in the right direction. The Federal Deposit Insurance Corporation (FDIC) recently implemented a risk-based premium assessment system that bases deposit insurance premium rates on each bank's capital and supervisory rating. These risk-based premiums will provide a market incentive for banks to improve the quality of their assets. However, as long as the insurance provider is a public agency it is unlikely that political considerations would permit a range of deposit insurance premiums wide enough to fully reflect differences in risk, or that such premiums would be changed

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[10]For a discussion and brief bibliography on the subject see Hoskins (1989); and Todd and Thomson (1990).

promptly when the condition of a bank changes.

The FDICIA's provisions and requirements for prompt corrective action, including regulator-mandated merger or closure, also move in the right direction and should reduce the Bank Insurance Fund's and the taxpayers' exposure to loss. Of course, there is some deadweight loss caused by the act of seizing a bank. Opinions differ about how much of those losses are merely the realization of embedded but concealed losses. If the costs of seizure are large, the Bank Insurance Fund might still incur losses, but the size of such seizure losses would be much smaller than for pre-FDICIA closings because early intervention itself reduces the final loss. Certainly there is no reason to believe that bankruptcy costs will be larger under early closure than they were with delayed closure before the FDICIA.

Seizure by regulators is something to be done when bank and regulator efforts to maintain soundness have failed. I want to focus on what can be done, assuming deposit insurance remains in place, to use market forces to reduce the cost of regulatory compliance and/or to increase the safety and soundness of banks. That is, I want to consider how the carrots and sticks of the market can be used to induce banks to become safer of their own accord, rather than through the micro-management efforts of regulators.

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 regulator, by a government agency? Indeed not. Market forces are very powerful and very efficient regulators.

Good planning by individuals and firms is facilitated by access to information that is accurate, adequate, and timely. Therefore, one approach that I want to suggest for using market forces for bank regulation is to require the disclosure of bank CAMEL and bank holding company BOPEC ratings, so that bank customers can make informed plans and decisions about where to do their banking business.[11] Such disclosure is now prohibited by regulatory decision, but is not clearly prohibited by law.

Regulatory agencies could prepare ratings in a form that is suitable for dissemination to the public. This might be in a summary rating or grading form such as is used for public disclosure of Community Reinvestment Act (CRA) ratings. Banks already are required to make their CRA evaluations public within 30 days of receipt.

In addition, I propose that the bank regulatory agencies publish a quarterly list of insured banks and their respective capital categories that regulators have assigned for purposes of the prompt corrective action (PCA) provision of the FDICIA. These categories are determined principally by the banks' capital ratios, which are derived from publicly available financial information.[12] However, capital categories are also influenced by other information available to the regulatory agencies such as applications filed, reports required under other banking and securities laws, and state examination reports. Thus, the PCA capital categories in some cases reflect a more current risk profile than the last available examination rating.

Similarly, the Federal Deposit Insurance Corporation (FDIC) should publish a list of

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[11]CAMEL and BOPEC are acronyms for rating reports issued by regulators on banks and bank holding companies, respectively. A bank's CAMEL rating is based on evaluations of its Capital, Asset quality, Management, Earnings, and Liquidity. A bank holding company's BOPEC rating is based on evaluations of its Bank subsidiaries, Other (nonbank) subsidiaries, Parent company, Earnings--consolidated, and Capital adequacy--consolidated.

[12]The data can be found in a bank's Report of Condition and Income, often referred to as the Call Report, which banks are required to file quarterly with their primary regulator.

insured banks and their respective Assessment Risk Classifications (ARC), which are used to determine risk-based deposit insurance premiums. This risk measure is also determined by capital ratios and regulators' supervisory risk ratings.

The Federal Reserve Board and the FDIC have chosen to prohibit depository institutions from disclosing PCA capital categories or ARCs. However, the law does not require the agencies to impose this prohibition.

Disclosure of a good risk rating could be an important marketing tool for banks, so banks would have increased incentive to earn a good rating. Market forces would reward highly rated banks with some reduction in deposit interest rates, especially for uninsured deposits, relative to those that banks with lower ratings would have to pay. This would not reduce the cost of complying with safety and soundness regulations, but would use market forces to increase the benefits of being safe and sound.

Releasing ratings would also put pressure on regulators to rate banks accurately. A regulator who repeatedly failed through its ratings to make timely identification of negative trends in bank soundness would be called to account by the public and, in the case of a Federal Reserve Bank, by the Federal Reserve Board of Governors and the Reserve Bank's own board of directors.[13]

Requiring disclosure of bank rating information would put in place a condition that would make the eventual curtailment of deposit insurance more practical, because depositors would have available the information necessary to protect themselves.

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[13]The Federal Reserve System's regulatory authority is generally vested by law in the Board of Governors, which delegates authority to the Reserve Banks.

For this procedure to be equitable, the supervisory agencies would need to coordinate to assure that they all use the same criteria for assigning ratings. Uniform standards are critical for this proposal to be successful, and for it to be supported by the banking community.

A supplement to requiring release of regulator ratings would be to encourage banks to voluntarily disclose aggregated data from their internal classifications of loan quality. This disclosure could be accompanied by estimated market or recovery value of loans in the bottom few classes, as well as income nominally due and income actually received from those classes. This would enable investors to more accurately judge the value of the common stock of the disclosing banks, and would be a step closer to the SEC disclosure approach to supervision. Willingness to make this disclosure could be a condition for participation in the other portions of this experiment in a market approach to banking supervision.

A second approach is that banks that have top CAMEL ratings and that are especially well-capitalized -- that is, banks that exceed by some 20 percent or 30 percent the thresholds now used by regulators for considering a bank to be well-capitalized -- could be given some relief from the frequency and intensity of examinations that are intended to enhance their safety and soundness.[14] Less regulatory oversight is needed to assure the safety and soundness of especially well-capitalized banks. Indeed, for sufficiently-well-capitalized

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[14]Regulators now 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 Federal Register (1992), page 44886. For definitions of these ratios, see Board of Governors (1989).

banks, there is the question of why there should be **any** safety-and-soundness-oriented regulation.[15]

We can reduce the burden of that portion of the examination process that determines asset quality by placing greater reliance on those banks' own internal systems of loan quality review and reporting after supervisory verification of the adequacy of the internal loan review systems. That would mean fewer officer-hours would be required to assist examiners in reviewing loan documentation. Similarly, in the case of banks that have strong internal controls and internal 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 interest rate risk measurement systems that examiners have reviewed could be exempted from having to establish and use the standardized interest rate risk measurement system that is currently being devised by the regulatory agencies.[16] These approaches would reward good management and strong capitalization while having no deleterious results for safety and soundness. By giving banks added incentives to be safe and sound, we would promote those objectives. Still another change would be to reduce the frequency of examination of such banks to greater than 12-month intervals, although this

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[15]After this paper was written, 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." See Office of the Comptroller of the Currency, et.al. (1993), p. 1. One part of that program could be added to the proposals in this paper. That part (see p. 2) says that "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 that there would be a limit "... on the aggregate of such loans a bank may make."

[16]A similar suggestion is made by LeRoy (1992).

would require legislation, because the FDICIA now mandates annual examinations

The opportunity for gaining a reduction in regulatory compliance costs would provide an incentive for less well-capitalized banks 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.

A third opportunity would be to establish a greatly streamlined regulatory procedure for certain bank mergers and acquisitions or non-banking activity expansions involving especially well-capitalized, well-run organizations. Such an organization that wanted to acquire another bank or engage in a non-banking activity that the Federal Reserve Board had already determined to be permissible would only be required to submit a letter notifying the appropriate supervising agency of its intentions and describing the activity.

To implement this procedure, the 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 must be well capitalized, all of its banks must be rated at least satisfactory for CRA performance, and the transaction can 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 are satisfied.

The Federal Reserve System already has taken this approach by reducing the regulatory requirements for state member banks to establish branches to a simple letter of notification and the required newspaper notice. Similarly, in 1992 the Federal Reserve published criteria for exempting a bank holding company from filing an application with the Federal Reserve if it is also filing a bank merger application with another banking regulator for what is essentially the same transaction. Normally, a bank holding company acquiring a bank must file an application with the Federal Reserve. When a holding company acquires a bank and immediately merges it into a bank that it already owns, it must also file an application with the regulator of the surviving bank. The exemption from filing with the Federal Reserve is available for those transactions.

To implement this concept would require some changes in the way the agencies deal with CRA comments and objections from community groups. Applications are sometimes significantly delayed when protests are submitted with respect to banking institutions' CRA performance. A considerable amount of time, correspondence, and sometimes public hearings are required to resolve issues raised in protests. In some cases, delays in applications processing result because the regulator was not aware of the issues at the time that the banks were examined for CRA.

The way regulatory agencies assess 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 request a meeting with the examiners. If the banking organization receives a good CRA rating and subsequently files an application, any CRA 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 believes that an issue raised previously has not been resolved.

This proposal is consistent with the 1989 Interagency Policy Statement on CRA that encourages community groups to bring their concerns to the attention of the bank and its supervisory agency at the earliest possible time.[17] In this way, issues can be resolved in a more timely and orderly fashion. Moreover, community groups will be given direct input into the CRA rating process. Banking organizations that receive good ratings, considering the broader input from community groups, would then be reasonably assured that their applications would not be delayed.

A fourth opportunity for using market forces in banking supervision is that bank holding companies with top BOPEC ratings that are especially well-capitalized and that are willing to give to the Federal Reserve explicit, legally binding commitments to be a source of strength to their banks could be rewarded in several ways. One way 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 subsidiary banks. Capital requirements, requirements for financial reporting and review, loan policy and supervision, etc., could be satisfied at the holding company level instead of having to be done at the level of 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 determined at the holding company level rather than at the subsidiary bank level. In addition, banking supervisors can expand the list of non-banking activities that are permissible for the nonbank

[17]See Federal Reserve Board, et. al. (1989), p. 13.

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 can be derived from that activity without being considered to be in violation of the prohibition against being "principally engaged" in that activity. Some of this would require changes in legislation.[18]

In summary, adoption of these four proposals 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 the banks to more easily attract capital, and thereby enhance their safety and soundness and their ability to expand, which would pressure other banks to become safer and sounder in order to increase their own competitiveness. Therefore, 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 will receive the benefits.

An additional benefit of these proposals is that they would require less regulatory attention to be given to banking companies that need less attention, which would allow some regulatory resources to be redirected to giving closer attention to those banking companies that are more in need of it.

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[18]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, et.al. (1993) p. 5. The proposals in the present paper can be viewed as specific procedures that are consistent with that objective of the four federal regulators.

V. THE MARKET FORCES APPROACH SHOULD BE TESTED

I believe that each of these four approaches should be tested by the regulators. That is, I propose (1) that banks be required to release their ratings to the public, and be required to release their internal loan quality assessments in aggregate form as a precondition for participating in the other portions of the test; (2) that companies with top CAMEL or BOPEC ratings that are especially well-capitalized be given relief from some regulatory requirements; (3) that applications from companies with top CAMEL or BOPEC ratings that are especially well-capitalized and that have good CRA ratings be given expedited treatment with a presumption in their favor; and (4) that bank holding companies with top BOPEC ratings that are especially well-capitalized and that give binding source-of-strength commitments be rewarded with supervision at the holding company level instead of at the subsidiary bank level. Although it would be desirable to test all four approaches, no one proposal is dependent on any other proposal.

Most of these proposals require no change in legislation. In those cases where a change in legislation is required, it would be desirable to have legislation that enables the experiment to go forward and provides for an evaluation of the results to be used as a guide to final legislation.

A test of these proposals on a small scale would have three advantages. A test is less costly than a nation-wide experiment. Changes and refinements can be made more quickly. And, because it will be clear to all concerned that it is a test and not a change in policy, it will be politically easier to reverse course in the unlikely event that the test is unsuccessful. Consequently, I believe that the test should be done in a region of the country rather than nationally. A Federal Reserve District would be a logical site for a test.

The test should continue for at least 3 or 4 years -- and ideally through a full business cycle -- so that its success can be sufficiently evaluated.

Several criteria can be used for evaluating the outcome of the test. If this new approach to regulation is valuable to banking institutions, there will be some shift of deposits to those banks that publish good ratings. The shift will be moderated to the extent that deposit insurance still exists and by the likelihood of a spread developing between the deposit interest rates paid by high-rated and low-rated banks. In addition, earnings of especially well-capitalized and well-managed institutions in the test region will rise relative to the earnings of similar institutions in other regions (adjusted for other factors that affect earnings). Moreover, the ratio of market value to book value for those institutions will rise relative to those outside the test area, while operating costs will show a relative decline. Especially well-capitalized and well-managed bank holding companies that are outside the test area will be pressing their banking supervisors to adopt the approaches being used in the test.

If this approach to supervision is valuable to customers, there should be a greater expansion of bank products and services in the test area than elsewhere.

Finally, trends in measurable indicators should emerge if this approach to supervision enhances the safety and soundness of institutions in the test area. Among them are (1) capital-to-asset ratios will rise, (2) the number of bank failures will fall, although initially there might be a jump as weak banks are culled, (3) credit ratings will rise, (4) the cost of issuing subordinated debt will fall, and (5) the interest rate on large (uninsured) certificates of deposit will fall, relative to national averages.

VI. CONCLUSIONS

In summary, the cost of complying with bank regulation is high, making it important to find ways of reducing that cost while still achieving appropriate regulatory goals.

Market forces can be used to lower the costs of regulation while enhancing the achievement of the regulatory goals of ensuring safety and soundness and fostering an efficient banking and payments system. Those improvements will help achieve greater efficiency and growth for our economy.

I believe that a test of these proposals should be undertaken, and should be started promptly.

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