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The Burden of Banking Regulation

Remarks

by

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at the

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There are times in the life of our Nation when it is probably the better part of wisdom for Federal Reserve Chairmen to be neither seen nor heard, and this may be one of them. In the light of that, you may wonder why I welcomed the invitation to speak to you today! I did so for a variety of reasons.

Implementation of the reserve requirements imposed by the Monetary Control Act is now only a few weeks off. As a result, the Federal Reserve will be thrust into a closer relationship with many of your institutions than ever before. Under the combined pressure of volatile markets, strong competition and insistent legislative initiatives to achieve social purposes, issues of both regulation and deregulation swirl about us as perhaps never before. Broad questions of the future banking structure of the country are being raised more actively than in the memory of almost all of us. Some of those questions arise from the rapid growth of international banking in general, and the continued penetration of foreign banks in the United States in particular. Others reflect technological change in banking and communication within the country, the pressures on thrift institutions to diversify, and competition from non-depository institutions. Substantial legislative and regulatory action has resulted -- the International Banking Act, expanded powers for thrifts, and liberalization of interest rate ceilings to name some of the most important. These changes, in turn, have helped expose for debate other, long quiescent issues revolving around the McFadden Act and the Douglas Amendment governing interstate banking.

I know and sympathize with the feeling of many bankers caught up in this situation that the capacity of their institution for change is "overloaded" -- that they hardly have time to adjust to new circumstances in one area before further requirements are thrust upon them. Certainly, to deal with these questions at all comprehensively would "overload" this speech, so I will confine my remarks to only a few of the issues.

The greatest threat to the cohesion and stability of financial institutions over time comes from instability in the economy itself and the value of money. We can be gratified that the "free fall" in economic activity that many sensed for a few months this spring rapidly dissipated, and that we can now point to many signs of recovery. The peak inflation rate of last winter has subsided. But it is also evident that the more fundamental problems that have developed over more than a decade remain. Productivity and savings remain abysmally low. Investment activity is hesitant. The lull in the upward sweep of oil prices -- following the doubling and more in 1979 and early 1980 -- cannot disguise our continuing vulnerability to foreign supplies and potential scarcity despite the gains in conservation that we are now making. And most important, we are face-to-face with the challenge of achieving economic recovery while turning down the underlying rate of inflation -- a process that, I believe, is essential to lasting growth and prosperity.

The volatile performance of interest rates and financial markets over the past year broadly reflects shifting concerns and judgments about whether those challenges can and will be met, and particularly whether inflation can be brought to bay. A year ago, I emphasized in my remarks to you the essential role and responsibility of monetary policy in dealing with inflation and inflationary expectations. That, of course, remains equally true today. It also remains true that our economic performance and financial markets -- and the effectiveness of monetary policy itself -- are impacted by other important public and private policies and actions.

The banking community can make no greater contribution, in its own interest, to economic and financial stability than by intelligent debate about, and support for, policies dealing with inflation, energy, and productivity. Your constructive interest in the structural reforms embodied in the Depository Institutions Deregulation and Monetary Control Act seems to me an apt case in point, directly assisting the conduct of monetary policy. More broadly, your strategic position in the economy provides an ideal vantage point for encouraging the sense of urgency, combined with understanding and patience, required to deal with problems that have concerned us over so long a period of time. As C.C. Hope has rightly emphasized, in connection with your inflation Task Force, "you can make a difference."

I doubt that many illusions remain among those in the banking world or elsewhere that the road to stability and growth will be unambiguously smooth or the journey painless. What is critical is that we face up to the problems -- as I believe we have begun to do -- and accept that progress toward our goals will entail changes in the way we go about our work.

In that process I believe you can legitimately ask whether those of us in Washington who regulate appreciate as fully as we might that same need to change our regulatory approaches. Do we avoid unnecessary burdens? In trying to protect what needs to be protected for a relative few, do we reduce the availability or increase the costs of financial services for the many?

I would be the first to confess that the pattern is mixed. I squirm

-- when a small bank writes, in response to our mailing of a new regulation, that "no one within 80 miles around here understands it;"

when we take 92 printed pages of regulation and some 1,506 interpretative letters and Court decisions to administer "Truth in Lending" (adding up to a pile of papers nearly two feet high);

when the Board of Governors alone approved 82 regulatory actions last year totaling over 1,000 typewritten pages, and the Comptroller of the Currency and the FDIC have their own comparable flows;

when the Board is engaged in such esoterics as whether the location of a branch bank or terminal must be identified on a customer receipt by state as well as street and city address;

and when, much more importantly, we almost constantly find ourselves closing unintended loopholes in regulations that cut across the natural workings of the market place -- regulations that over time could better be abandoned.

The point has been made to me that the spewing out of complex regulations, applicable to all institutions big and small, may be a larger threat to the economic viability of our smallest banks than any branching statute because only the larger institutions can possibly have the expertise and specialization to know the regulations. Nor can it make sense to burden our regulated institutions to the point that their competitors can grow more rapidly.

That litany of evils is familiar stuff. The operative question is how to deal with it. I sense the climate of opinion, in the Congress and elsewhere, is becoming more sensitive to the problem. But we have a long distance to go in identifying the most productive lines of reform -- after a number of years in and out of Washington, I have a certain skepticism that simply mandating more levels of bureaucratic review of what we bureaucrats do is likely to be a productive approach. In many cases, substantive changes in legislation, mandating regulation in great detail, will be necessary. And most difficult of all, we will have to resist the temptation that Federal regulation is an appropriate answer to every problem or abuse that can be identified.

Those interested in lightening the regulatory load will, in my judgment, be more effective if they take as a point of departure that nearly all regulations today have their roots in a perceived and legitimate public interest that needs to be served. For instance, the special role of banking in our economy is reflected in deposit insurance, in a rather elaborate network of facilities to support or cushion weak and failing institutions, and in protection from competitive excesses. The logical counterpart to this government support for your business is regulation to protect the public interest in the safety and soundness of the banks. Another area of regulation that will persist -- a type of regulation increased in coverage by the Monetary Control Act -- flows directly from the needs of monetary policy.

Much more controversial are the series of regulations -- typified by Regulation Q and restrictions on branching, mergers, and holding companies -- designed to protect or enhance a particular market structure, or to shield institutions from competition. In this area, regulators may often be more enthusiastic about deregulation than many of those regulated. But even the strongest proponents of deregulation are forced to recognize that too sudden change could undermine the stability of many financial institutions, and be disruptive to the economy as a whole.

Finally, and most important in terms of sheer volume in recent years, is the spreading legislation aimed at social purposes and a fair distribution of credit. In this area of Truth-in-Lending, Equal Credit Opportunity, the Community Reinvestment Act and Electronic Funds Transfer there has been massive proliferation of rules and regulations governing some of the terms and conditions of literally millions of credit and deposit transactions. Concepts of what is "right" or "wrong," "fair" or "unfair" are hard to judge at the margin. Those concepts sometimes cut across and conflict with commercial judgments. As a result, we have a fertile breeding ground for complexity, laborious dispute resolution procedures, new costs, and mutual aggravation. Yet, it seems idle to think that the basic objective will be, or should be, foregone.

If, in the face of these needs and circumstances, a vision of no regulation is impracticable, how best to proceed? Let me suggest at least four approaches.

First, we can, I believe, legitimately draw distinctions in some areas of regulation between larger and smaller institutions. I know that involves arbitrary judgments about size, and cuts directly across our traditions of treating everyone just alike. But treating everyone alike in principle can, in practice, lead to differences in burden.

I do not mean that small banks should in general be wholly exempt, but rather that there can be opportunities for greatly simplified regulatory and enforcement procedures. We are cautiously (perhaps too cautiously) experimenting in this area in the application of the Monetary Control Act, where reporting and reserve maintenance calculations will be much less frequent for the smallest financial institution. The new Small Business Regulatory Flexibility Act points in the same direction, and we intend to move forward as quickly as we can to reexamine all our regulations in the light of that statute. The need and opportunity seems to me particularly great in the area of "social" regulation, where smaller institutions typically do not have the capacity to analyze and implement all the complications of the regulations -- but neither are their operations so complex as to require pages of regulatory instructions.

Somewhat along the same lines, I would suggest that we could achieve the basic objectives of our "social" regulations with much less cost -- I would like to think 90 percent of the purpose with 10 percent of the regulatory language and institutional effort -- if the basic legislation refrained from demanding precisely the same disclosures and treatment for all transactions, however infrequent they might be. The main purpose -- say understandable receipts or intelligible interest rate computations -- must be clear, and it is usually helpful to spell out the requirement explicitly for the common types of transaction. But, if the goal is clear and penalties not disproportionate, surveillance by informal counseling or through the normal examination processes should be able to substitute for detailed regulation of the more unusual transactions.

Perhaps most importantly, legislators, regulators, and the regulated need to be aware that the burdens and inequities of regulation multiply when they run counter to strong market incentives. In some areas -- say, capital requirements -- there may be strong public purposes dictating the regulatory intervention; indeed the strong competitive pressures among institutions pushing toward more leverage of capital may justify enforcement of more arbitrary "rules of thumb" for the industry as a whole than would seem reasonable for the best managed institutions. But our experience with regulating interest rates on deposits is more typical; as the difference between the rates institutions are willing to pay, and what they are permitted to pay, widen, two consequences are inevitable. The regulated institutions will grow less rapidly, and they will constantly innovate to test the bounds of the regulation, generating new regulatory efforts to protect the old.

In particular situations, that regulatory effort may be justified for a time. Under present conditions, for instance, a large number of institutions and the markets they serve, for historical reasons, would be severely dislocated by an abrupt termination of all deposit rate ceilings. So long as that situation can be demonstrated, the regulators have no real choice other than to maintain the effectiveness of the regulation, dealing with loopholes as they appear. But it is equally evident that the regulations should be progressively relaxed just as soon as conditions permit -- and, as I understand it, that is precisely the intent of the Congress in delegating authority over those ceilings to the Depository Institutions Deregulation Committee. I might point out that the objective of deregulation of interest rate ceilings would be greatly facilitated by progress against inflation -- progress that would naturally bring in its wake a declining trend of interest rates.

Finally, I am convinced there is a great deal more we can do, as regulators, in getting the essential message of our regulations across in simple, readable English, better tailored to the particular needs of the recipient. To take one egregious recent example, no credit unions, and very few banks, need to know how to deal with Euro-dollars when computing their reserve requirements, yet those subtelities now take up pages of regulation routinely sent to all institutions.

While many of the results may not yet be visible to you, we have undertaken a substantial effort to review and simplify our own regulations wherever possible. A small group of professionals has been working full time on that effort in Washington, and we have enlisted the help of the Federal Reserve Banks which are closer to your operating problems. More stringent internal controls have been established for new and old statistical reports, and, believe it or not, I can demonstrate tangible progress in reducing the data received from member banks.

We have tried in the limited time available to apply some of those lessons to the implementation of the Monetary Control Act. But I sense we are still only scratching the surface.

As we reach for further improvement, we would welcome your cooperation in working with us. We may not always agree on what is essential and what is not -- and it is not unknown, I would remind you, for bankers to press us for new regulations or for information we do not collect!

Indeed, your own actions indirectly can inadvertently have a great deal to do with the regulatory process. The Congress tends to respond to perceived abuses. A relative handful of legitimate consumer complaints, a clear pattern of discrimination by a few institutions, incidents of conflict of interest or self-dealing by a few bank managements -- like it or not -- make news and generate pressure to "do something" about it. And if the broad intent of remedial legislation seems to be skirted by exploiting areas of legal fuzziness or loopholes, the response is likely to be still more legislation or regulation.

I know no industry as large and varied as banking can, however vigilant, anticipate and correct every possible complaint or abusive practice. Yet, in this day of open Government and close corporate surveillance, I cannot emphasize too strongly how important it is, working through your trade associations and otherwise, to demonstrate that the industry generally is voluntarily dedicated to maintaining high banking standards.

One current example of significance for perhaps no more than two dozen banks, is the practice that has developed over a number of years to manipulate certain Euro-dollar transactions to reduce reserve requirements artificially. While no law or regulation has prohibited the practice, it does distort the international payments sytem and competitive relationships. The practice seems to be spreading, and we have asked the few banks engaging in the practice to cease. I feel certain they will cooperate, and we will not be impelled to develop complex new regulations to deal with the situation. You are aware, I am sure, of the concern over remote disbursement and delayed availability of funds -- areas where I believe we can also find solutions without being driven into heavy-handed regulation.

I would also note that, to the extent an industry calls upon governmental assistance, the more it opens itself to government regulation. You may not associate banking with exceptional requests for government aid -- and neither do I. But I would remind you troubled banks do as a matter of course expect assistance, and every failure or near-failure involving such assistance to some degree strengthens the hand of the would-be regulator. I, as you, have opposed sweeping extension of deposit insurance coverage partly because I believe that, over time, the result would be more intrusion by government into your internal management.

I am very conscious of the fact that I can offer no blinding vision of deregulation en masse this morning. But I am convinced we can turn the tide that has been so strong. In my judgment, it's not a job that we, or the financial industry, can do effectively alone. But with mutual understanding, we can identify more clearly the central needs, cull out what is essential from what is not, meet the essential needs more efficiently, and rely to the maximum extent on competitive processes and market disciplines. It is in that spirit that I particularly welcome the formation of your Deregulation Task Force. Regulations take up even more of our time than yours, and we both have an enormous stake in doing it right!