"A Framework for Regulatory Relief" - Remarks of FDIC Vice Chairman Thomas M. Hoenig, presented to the FDIC Community Banker Conference, Arlington, VA

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Introduction

The United States has a long history of economic success under a decentralized and diversified banking system. Commercial banks, ranging in size from small to very large, have successfully served the credit needs of individuals, small businesses, and large international firms. This success was based on a business model wherein the banker serves as a trusted intermediary between savers and borrowers. Using this model, the banking and financial industry created and supported the largest, most dynamic economy in the world. But things have changed, and the community bank model has come under enormous competitive and operational pressure -- so much so that some are asking if the model is sustainable. In my view it is, but not without some fresh thinking and concerted effort.

Consolidation

Over the past 30 years traditional community banks have become less influential as they have lost market share of credit allocation within the economy and as their numbers continue to decline.

The consolidation of the credit channel within the United States in recent decades has been dramatic.[1] For example, in 1984 the distribution of assets among community, regional, and money center banks was nearly proportional, with more than 15,000 commercial banks serving a variety of borrowers, from consumers and small businesses to global conglomerates. Today, the 20 largest banks by assets control more than 80 percent of industry assets, and the number of banking firms has declined to less than 6,200. The group of community banks with less than $1 billion of assets,

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[1] Consolidation of the Credit Channel: https://www.fdic.gov/about/learn/board/hoenig/creditchannels.pdf

which in 1984 controlled nearly a third of banking assets, today controls less than 10 percent of industry assets.

These trends put us on a path toward a system in which a few very large financial firms control the allocation of credit within the national economy. It is unclear, to me at least, whether this structure in the longer term will support a vibrant, competitive system, able to serve the present and future needs of consumers and business, or if it will become a highly concentrated, controlled distribution system for credit. At a minimum, therefore, consolidation in the banking industry deserves attention regarding its effects on competition and reduced consumer and business options.

While any number of factors might contribute to consolidation, I would note at least four.

First, branch banking laws were substantially liberalized. Where banks were once confined to local or state boundaries, in the 1980s and '90s state and federal laws removed these barriers. While this change was inevitable and necessary in an open economy, it also enabled and accelerated the banking industry's consolidation.

Second, activities insured banks are permitted to conduct -- including insurance, investment banking, broker-dealer activities, and trading -- have significantly expanded, as codified in the Gramm-Leach-Bliley Act of 1999. The effect of this change has been to encourage and accelerate consolidation among the largest financial firms in the United States, both within the banking industry and among the largest commercial and investment banks and some insurance companies. It has contributed to an enormous increase in the concentration of the industry and an increase in the systemic risk facing our economic system.

Third, monetary policy has sustained an interest rate environment near zero for almost a decade. This has significantly affected the ability of community banks to maintain net interest margins, manage risks, and achieve returns necessary to operate safely and profitably. The result has been increasing numbers of community banks exiting the industry and fewer investors seeking new charters.

Finally, in recent decades there has been an obvious and significant increase in bank regulation and regulatory burden. Traditional community banks face a compliance burden that seems disproportionate to their risk profile and sometimes unrelated to their activities. One effect is further industry consolidation as small banks drive to reduce average overhead and compliance costs using mergers to build assets. I want to focus the remainder of my remarks on this trend and how we might address it.

Regulatory Relief for Traditional Banks

To mitigate some aspects of regulatory burden and provide greater flexibility to the majority of banks operating in the United States, I have suggested a path that focuses on bank activity, complexity, and funding sources. Such an approach is designed to provide regulatory relief that is meaningful for all banks engaged in traditional commercial banking -- mostly community and some regional banks -- without diminishing safety and soundness, or consumer safety and access to service. The model I recommend is not mandatory and, importantly, it abandons the reference to size thresholds, with their confusing benchmarks and varied demands and exceptions that add confusion and burden.

First, I suggest defining a traditional bank eligible for regulatory relief as one that:

- holds no trading assets or liabilities;
- holds no derivative positions other than interest rate and foreign exchange derivatives;
- has total notional value of all its derivatives exposures -- including cleared and non-cleared derivatives -- of less than $8 billion; and
- maintains a ratio of Generally Accepted Accounting Principles tangible equity-to-assets of at least 10 percent.

A bank with sufficient capital that doesn’t engage in high-risk trading activities and investment strategies with funding subsidized by the FDIC and the Federal Reserve poses less of a risk to the financial system. Such an institution should not face the same regulations and supervisory requirements that apply to complex firms involved in both trading and traditional commercial banking with lower levels of capital. Banks with at least 10 percent equity capital have lower rates of failure and stable rates of lending over the course of an economic cycle[2]. In addition, and importantly, a majority of commercial banks already meet the 10 percent equity capital level.

Defining eligibility for regulatory relief around these specific criteria, rather than asset size, reflects the longstanding business models of traditional commercial banks. Doing so recognizes that many sources of regulatory burden have been put in place in reaction to the increasingly complex and risky nature of the activities that some banks have chosen to pursue. Since these criteria are objective and readily apparent from a bank's balance sheet, the eligibility requirements can be enforced relying on existing Call Report fields and the regular exam process.

With this framework in place, regulatory relief for traditional banks can be achievable. Some of the regulatory changes that are imminently reasonable include:

- exempting traditional banks from all Basel capital standards and associated risk-weighted asset calculations;
- exempting these banks from several entire schedules on the Call Report;
- allowing for greater examiner discretion and eliminating requirements to refer "all possible or apparent fair lending violations to Justice," if judged to be minimal or inadvertent and where restitution is voluntarily made;
- establishing further criteria that would exempt eligible banks from appraisal requirements allowing them to prepare internal appraisals to be reviewed by examiners;
- exempting banks, if applicable, from stress testing requirements;

[2] Capital and bank failure levels: https://www.fdic.gov/about/learn/board/hoenig/idichart.html
Capital and bank lending levels: https://www.fdic.gov/about/learn/board/hoenig/lendingcharts.pdf

- adjusting the examination cycle for well-rated banks to 18-months, from the current required 12-month cycle;
- defining mortgages made and that remain in a bank's portfolio as qualified mortgages for purposes of the Dodd-Frank Act;
- reducing certain reporting requirements for HMDA.

Capital Strength

The 10 percent capital level I have recommended as one of the criteria for meaningful regulatory relief, as I noted earlier, reflects a position from which banks are less likely to fail and a position from which they can best hold loans and serve customers during even the most severe downturns. This amount of owner equity, therefore, serves to assure the public that the bank is soundly capitalized and deserves its confidence.

It also is worth noting that most community banks currently meet this capital requirement and already would be eligible for relief under the framework I have outlined. Almost 95 percent of banks meet the business model tests. More than half meet the 10 percent capital requirement for eligibility, and 74 percent are over 9 percent. Those that are not at 10 percent would be given immediate relief if they commit to an 18-month phase-in period to reach 10 percent.

In putting forward this framework, I recognize that it is not a cure-all. It will not end consolidation caused by costs and other industry factors. However, it does address one source of cost for traditional banks, and it does so without weakening the overall strength and accountability of the sector. In addition, if community and regional bankers have other specific areas of law or regulation that could reasonably be eased for traditional banks, I encourage their recommendations.

As a side note, I have been told that the industry cannot support this proposal because not all traditional banks have 10 percent equity. I find this position unsettling because most banks can in fact obtain this capital threshold through retained earnings and because such a position by the industry as a whole effectively denies the majority of community banks significant regulatory relief. Remember, banks that choose not to meet the eligibility test I have suggested, because they prefer to operate with lower capital levels, may continue to do so, but at the price of greater regulatory oversight and compliance burden.

Alternative Approaches

The framework I've outlined is a legislative remedy to address regulatory burden. Other avenues are also available, including the EGRPRA regulatory review conducted every 10 years as mandated by the Economic Growth and Regulatory Paperwork Reduction Act and other legislative proposals such the TAILOR bill designed to streamline rules through the regulatory process.

While I would encourage useful regulatory relief from any source, my point remains that to achieve meaningful and long-term regulatory relief, it is necessary to change the statutes from which the burden flows. I would encourage the community banking industry to review this proposal with those goals in mind.

Closing Thoughts

In closing, I want to caution community bankers on one vital point. Regulatory relief is important, but by itself it will not save the community bank model. Many among you have told me that your model of relationship banking, while strong, must adjust to the competition with its ever changing face and force. Attracting funds, developing loan products, and improving payments products is no longer a business unique to the banking industry. Other financial competitors are intensifying their efforts to capture your market, and community banks must adapt. While product platforms can be outsourced, products offered on those platforms must constantly be refreshed, which requires the community banking industry to apply its insights and inputs to improve its offerings.

The community banking industry, through its trade associations and other means, therefore must become ever more strategic and effective as it develops and delivers new products. Changes in technology are just one example of how the community banking industry must work together, not only to battle the challenges of the present but also to grasp the opportunities for the future.

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The views expressed are those of the author and not necessarily those of the FDIC.

Thomas M. Hoenig is the Vice Chairman of the FDIC and the former President of the Federal Reserve Bank of Kansas City. His material can be found at http://www.fdic.gov/about/learn/board/hoenig/