Remarks
FDIC
Vice Chairman John Reich
Exchequer Club
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Good afternoon. I'm delighted to have both the honor and the pleasure of being here with you today. I'd like to talk about a subject that is important to me—and that's the crushing impact of regulatory burden on community banks. I'm here to add my voice to those who believe accumulated regulatory burden – which impacts the entire banking industry - is now beginning to choke an important sector of the banking industry.

When I was a community banker in Florida more than 15 years ago, I never dreamed that one day I would find myself in Washington, D.C. leading the charge against a problem that at the time, and even now to many, seems almost insurmountable. I'm glad to have this opportunity.

When FDIC Chairman Don Powell asked me early last year to lead the interagency initiative under EGRPRA —the Economic Growth and Regulatory Paperwork Reduction Act of 1996—I saw it as an opportunity to have a hand in addressing a longstanding problem. I knew of course that we would face tremendous obstacles.

Also, having spent a number of years on Senate staff, I know how hard it can be to build coalitions and get things done. Given the entrenched nature of regulatory burden, I was not at all surprised at the level of apathy and skepticism many expressed as we launched our initiative in July of last year. I didn't particularly want to raise unrealistic expectations. Nor did I want the effort to be perceived as a Don Quixote expedition, tilting at windmills. But I also didn't want to set the bar too low.

Bankers have often told us that if we're going to do anything, be bold. Don't tinker at the margins, which would only create more burden with no real relief. I agree with this premise, and I am quite willing to take on issues generally regarded as sacrosanct because this is a problem – you may be beginning to gather – that I feel strongly about.

After a long career in banking and a second career in government, I believe regulatory burden is a problem for the entire banking industry from Citibank to the smallest community bank in North Dakota, and the incontrovertible fact is - regulatory burden disproportionately impacts smaller community banks. I'm absolutely convinced it is becoming a problem of such magnitude that community banks are now suffocating under the weight of accumulated regulation. If we are going to continue to have a community banking industry, this is a problem we must solve. This is my highest priority as Vice Chairman of the FDIC.

Some may say – what about your free market principles -the consolidation of the industry is simply the free market at work. I believe in free markets, and allowing

markets to work. I don't believe the banking industry is a free market. According to the MIT Dictionary of Modern Economics, a free market is "A market in which there is an absence of intervention by government and where the forces of supply and demand are allowed to operate freely." If you would have been in a meeting room with me at the Mayflower Hotel last week listening to over 100 community bankers sound off on how regulatory issues are impacting and impeding their operations, you might conclude the market is not so free. Eight (8) outreach meetings around the country during the past 15 months from New York to Seattle and 6 cities in between have given bankers the opportunities to express similar thoughts about an over-regulated industry.

Today I'd like to focus on three aspects of the issue.

why our regulatory burden reduction efforts matter.
the progress we're making with the EGRPRA initiative.
some larger solutions worth considering: including a two-tiered regulatory concept, and creating better consumer disclosures.
Let me begin by saying that bank regulation obviously serves a clear and important purpose. No one in this room would dispute that statement. Our regulatory system has provided the framework for the most successful financial services industry in the world, while protecting the safety and soundness of financial institutions and the consumers who are served by them. Bank regulation must continue to serve these highest of purposes.

Today's rapidly evolving, increasingly complex financial services industry poses an even greater challenge for regulators than in the past. With some financial conglomerates holding more than $1 trillion in assets, protecting safety and soundness is an ever-growing responsibility. With a greater array of increasingly sophisticated financial products and instruments, protecting consumers must remain a top priority.

But when unnecessary, outdated, unduly burdensome, or duplicative regulations accumulate to their present magnitude, and the cost of compliance escalates to the level it currently represents on bank income and expense statements, it becomes critically necessary to find solutions. The explosion of new regulations in recent years has made that job all the more challenging and all the more important.

Since 1989, 801 new rules, regulations, and amendments to existing rules have been imposed on the industry, on top of what already existed prior to that time. That amounts to an average of more than 50 new rules, regulations, or amendments every year.

Regulatory burden is hard to measure, because it tends to become indivisible, if not invisible, from a bank's other activities. Still, if you look at the various studies that have been done in the past, the cost of compliance with accumulated regulations amounts to about 12 to 13 percent of a bank's non-interest expenses. Now-outdated research by the American Bankers Association and the Federal Reserve in the 1990s indicates that the total cost of compliance for banks today would range from $26 billion to $40 billion a

year. A reduction in regulatory burden which could redirect resources to bank capital would have a very positive impact on the lending capacities of community.

Every change in reporting requirements or modification of business practices involves new capital expenditures and increased human resources, computer programming costs and vendor expenses. One survey suggests that in the aggregate small and frequent changes to regulations may cost even more than big, infrequent changes. Regulations with high fixed costs fall the hardest on the smallest banks, because these banks lack economies of scale.

Jim Hance, Vice Chairman of Bank of America, summed up the situation by saying, “All banks are being mandated to install more and more compliance-related technology—for issues ranging from anti-money laundering to Basel II. Scale allows us to do so far more efficiently than smaller competitors.”

I’m concerned that community banks, bearing a disproportionate impact of regulatory burden, are becoming less and less viable as regulations accumulate. A 1998 Federal Reserve study states:

“Average compliance costs for regulations are substantially greater for banks at low levels of output than for banks at high levels of output. This conclusion has important implications. Higher average regulatory costs at low levels of output may inhibit the entry of new firms into banking arena and stimulate consolidation of the industry into fewer, larger banks.”

The number of community banks has declined dramatically over the past 20 years, (See Chart) and their share of the industry market, earnings, and quality of profits has also declined:

1. At the beginning of 1985, there were 11,780 small community banks with assets of less than $100 million in today’s dollars. At year-end 2003, their number had dropped by 63 percent to just 4,390.
2. The total market share of industry assets held by those institutions decreased from 9 percent at the beginning of 1985 to just 2 percent at year-end 2003.
3. Their share of industry earning over the past 20 years has declined from 12.3% to 1.7%.
4. The Return on Assets of banks with assets over $10 Billion was 1.42% last year; the ROA of community banks with assets under $100 million was 0.95 %. It is indeed a tale of 2 industries.

Distribution of Insured Banks and Thrifts by Assets Size December 31, 2003

Assets Size	Number of Institutions	Percent of Total	Cumulative Percent	Asset Share	Earning Shares
Under $100 million	4,390	48%	48%	2.5%	1.7%

$100 million - $1 billion	4,211	46%	94%	12.8%	10.8%
$1 billion - $10 billion	471	5%	99%	14.5%	14.5%
Over $10 billion	110	1%	100%	70.2%	73%
All institutions	9,182	100%		100%	100%

- For the year 2003, 6% of Industry earned 87 ½ of the Profits;
- 94 % of the Industry earned 12 ½ % of the Profits
- Banks over $1 Bil earned 1.42% Return on Assets (581 banks, representing 6.3% of the industry;
- the 4.211 banks from $100 Mil to $1 Bil earned 1.18 % ROA;
- the 4.390 banks under $100 Mil earned 0.95% ROA.

I'm not sure anyone knows the answer to the question – what role – up to now - has regulatory burden played in the decline in the number of community banks? Yet I'm confident in my belief that regulatory burden has played such a role and is an increasingly serious problem for community banks. There are an increasing number of community bankers who are seriously considering selling their institutions because of the impact that steeply increasing compliance costs are having on their institution's profitability. Some people don't believe that statement but I've heard it often enough over the past year that I do believe it. Their directors and major shareholders increasingly are asking: "How much longer can we afford to stay independent before we consider realizing the present value of our investment?" Others have commented that an "exit strategy" is becoming a necessary part of their business planning.

The community banking sector has traditionally been a vibrant part of this country, providing leadership and financial support to communities and countless individuals, families, small businesses, and municipalities. Yet this sector is not necessarily a permanent part of our financial landscape. The impact of regulatory burden on these institutions should not be underestimated, and it is one of the most compelling reasons why this interagency effort needs to be successful. I firmly believe that without a change in the attitude and approach by policymakers to small bank supervision, the community bank may be an endangered species in our society.

You now know why I think regulatory burden matters – let me say a few words about where we stand in making progress.

The EGRPRA initiative is moving forward, although at a slower pace than I'd like. From the outset, my colleagues—FDIC Chairman Powell, Federal Reserve Governor Susan Schmidt Bies, OTS Director Jim Gilleran, former Comptroller of the Currency Jerry Hawke, and former NCUA Chairman Dennis Dollar, along with many others—have joined us in promoting the EGRPRA effort and meeting with bankers and consumers to raise awareness and hear their concerns. We have made it clear to all of these groups

that in our efforts to find unnecessary, outdated and burdensome regulations, we will never abandon our commitment to safety and soundness, nor to consumer protection.

Since the project began 15 months ago, we've held 11 Outreach meetings around the country - 8 banker outreach meetings and 3 consumer \ community group meetings, with more than 700 participants. We developed a "Top Ten" List of banker concerns and posted it on our EGRPRA website along with a lot of information about our efforts.

Since last June we've also issued five categories of regulations for comment. Over 700 comment letters have been received. The agency staffs are busy analyzing those comments and making recommendations. I think there are a pretty good number of lower profile recommendations we can agree on. In addition,

We've reached an agreement on legislation to eliminate certain reporting requirements regarding extensions of credit to insiders, as well as three legislative proposals to streamline certain kinds of applications.
We're moving ahead with a project to simplify Privacy Act notices by agreeing to do consumer testing to determine the best possible language for those notices.
We've also agreed it makes sense to repeal the provisions prohibiting depository institutions from paying interest on demand deposits.
We're also working with FinCEN to develop modifications to the CTR filing requirements under the Bank Secrecy Act to reduce regulatory burden.
We've also made a list of legislative recommendations to Congress, and Senator Crapo is crafting a bill incorporating many of those recommendations.
We are 15 months into this three-year initiative. We continue to press forward with a good deal of energy and enthusiasm for the project but we will clearly need interagency consensus along with industry support to achieve real success. I have no doubt about industry support. Interagency consensus is my biggest challenge.

For my third and final point – our work on EGRPRA has only heightened my awareness that today's single regulatory system does not seem appropriate for large and small banks alike.

A natural outgrowth of our effort has been to consider in greater depth the possibility of a two-tiered approach to regulation. The industry is increasingly divided into a small number of financial conglomerates and a large number of small banks, although that number is a constantly decreasing one. This division is not absolute, because there are still quite a few medium-sized banks (471 in number) between $1 billion and $10 billion. Nonetheless, the industry is far more bifurcated now than in the past. This begs the question of why we continue, for the most part, to have a "one size fits all" regulatory system.

The difference between large and small banks is also evident in their comparative ability to comply with regulations. Small community banks as a group simply do not have the staff resources that larger banks have to monitor compliance with the full panoply of

regulations. As regulatory burden has grown, smaller banks have had to continually do more with less.

Given the dramatic differences between megabanks and small banks, we have to question the wisdom of continuing to use the same system to regulate all institutions. The distinction drawn in devising a two-tiered approach might be based solely on size, or perhaps complexity – whether it's a typical community bank offering traditional services, or a more complex institution offering more diverse products and services. The difference between complex and non-complex banks may be a clearer and ultimately more preferable distinction than the difference between large and small. However we draw the distinction, it's clear that these institutions are qualitatively so different that it makes little sense to supervise and regulate them in the same way.

In many respects, we already have a de facto two-tiered approach in place in some areas. The FDIC's MERIT examination program offers more streamlined examinations for certain well-capitalized, well-managed banks with assets of up to $1 billion. The Basel II Capital Framework will result in a two-tiered system for capital regulation: one for large, internationally active institutions, and one for all others. In addition, we have a dedicated examiner program that assigns an examiner to very large banks. And recently, the FDIC proposed more streamlined Community Reinvestment Act examinations for banks with assets up to $1 billion, while requiring that institutions with assets between $250 million and $1 billion meet a mandatory community development test.

We also make distinctions in other areas—such as HMDA reporting for the Home Mortgage Disclosure Act, Call Report requirements, civil money penalties and receivership treatment.

Several two-tiered concepts have been put forward and deserve consideration. Besides looking more carefully at a two-tiered approach, I think we should also take a careful look at the large number and the actual content of consumer disclosures required by law. Beginning with the Truth in Lending Act 35 years ago and culminating with the recently enacted Privacy and FAC T Acts, a total of 60 different consumer disclosures are now required for typical consumer transactions. This raises several questions. Are the numbers of disclosures too many for banks and consumers to deal with effectively? Do consumers find them too complicated, conflicting and duplicative? Are these disclosures failing to achieve their designated purpose in helping consumers become informed customers of financial services? I believe we need to look at the whole panoply of disclosures and find a way to eliminate the overlap, duplication and confusion.

In summary, we are taking methodical and sensible steps toward the goal of removing regulatory burden from our financial system. The EGRPRA initiative represents an significant first step in carefully finding and eliminating the burden so deeply embedded in our regulatory system.

Beyond EGRPRA, a more comprehensive look at a two-tiered approach could well give us a more global solution to regulatory burden. And, of course, rationalizing consumer disclosures could result in big improvements and make it easier to achieve the original goal of informing and protecting consumers.

It's time to re-establish a better balance in our regulatory system. This is an ongoing process, and I believe we are moving in the right direction—and I'm very hopeful that with continued interagency cooperation and support, along with industry consensus, we will achieve what most have thought impossible – true reduction in the weight of accumulated regulations on our banking industry.

Thank you.

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