A Market Approach to Banking Regulation

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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. These costs, in effect, 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 lowers 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.

In this paper I 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 lower 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 for lowering the cost

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

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 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 or 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 would 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 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 sources. The proliferation of alternatives to banks in recent years suggests that the SEC approach is superior and that a shift of sources is indeed occurring. The increasing availability of bank-like services from finance companies, mutual funds, brokerage houses, and insurance companies suggests that regulated depository institutions are holding on to a shrinking share of the intermediary services market. Economists do not 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.

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, it 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 worthwhile to remember that some well-respected scholars formerly saw great merit in a basic level of deposit insurance. Milton Friedman and Anna Schwartz, for example, describe federal deposit insurance as "the structural change most conducive to monetary stability" (1963: 434), and "a form of insurance that tends to reduce the contingency insured against" (1963: 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 (FSLIC) in the savings and loan 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 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 loans that held the possibility

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

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 (Kane 1989).

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 FSLIC, 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 (Woodward 1992; Thomson 1993). 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 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 well-capitalized, well-managed institutions and marginally capitalized, inadequately managed ones. 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:

- 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.
- 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 institutions in their condition.
- Banks that are sick but potentially viable 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.

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 percent to 14 percent of commercial banks' non-interest expense (Federal Financial Institutions Examination Council 1992: C-15). 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.[3]

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 forgoing 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 and 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 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 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.

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

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-market theory suggests that other financial firms will enter those activities and serve those areas, so it is possible that substituting nonbanks 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 includes 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, causes 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 (D.–Tex.), 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."[4] A variant of this view is that banks should be treated as public utilities.[5]

[4]Quoted by Barbara Rehm (1992: 14).

[5]For example, Albert Wojnilower (1993: 4–5) asserts that "Both the payments and the credit system have been and should continue to be regarded and treated as public utilities. Banks should not be required, encouraged, or even allowed, to withdraw from lending and

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 gaining access to financial resources through the political process rather than through competition for funds based on the merit of the investment. One example is the call for a national investment policy that was heard a few years ago. Another is the efforts of consumer-oriented individuals or groups, using leverage provided by the Community Reinvestment Act (CRA), to reach agreements with banks to make loans or investments 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 credit to all neighborhoods in a community—can be impeded when the requirements for compliance become an instrument for seeking resource redistribution that was not intended by the legislation.

Achieving Regulatory Objectives by Using Market Forces

Large cost, per se, does not 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 high cost of compliance with bank regulation does strengthen the argument for analysis to determine if the benefits of regulation exceed the cost.

Even without a cost-benefit analysis, which is beyond the scope of this paper, it is clear that lowering the cost of achieving regulatory goals is desirable. The Federal Financial Institutions Examination Council's (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 further the same goal.

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.

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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."

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.[6] 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 receive 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.

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 to introduce coinsurance, while taking steps to expand the amount of information about banks that is 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 will not elaborate on it here.[7] Even though this approach makes good economic sense, substantial political barriers stand in the way of 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,

[6]Proponents of this approach and its variations include Milton Friedman (1960: 65–75), James Tobin (1987), Robert Litan (1987), and Lowell Bryan (1991). Ronnie Phillips (1992) discusses the influence of this proposal on banking legislation in the 1930s. Critics include Bert Ely (1991) and Donald Simonson (1991).

[7]For a discussion and brief bibliography on the subject, see W. Lee Hoskins (1989) and James Thomson and Walker Todd (1990).

that depositors do not have sufficient information to evaluate the soundness of the banks in which they keep their money.

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 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 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 becomes necessary 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 micromanagement 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 powerful and efficient regulators.

Disclosure of Ratings as a Marketing Tool

Good planning by individuals and firms is facilitated by access to information that is accurate, adequate, and timely. Therefore, one approach 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.[8] 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 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 banks' capital ratios, which are derived from publicly available financial information.[9] 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 does the last available examination rating.

Similarly, the FDIC should publish a list of 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

[8]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 *C*apital, *A*sset quality, *M*anagement, *E*arnings, and *L*iquidity. A bank holding company's BOPEC rating is based on evaluations of its *B*ank subsidiaries, *O*ther (nonbank) subsidiaries, *P*arent company, *E*arnings—consolidated, and *C*apital adequacy—consolidated.

[9]The data can be found in a bank's Report of Condition and Income, often referred to as

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.[10]

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 access to the information necessary to protect themselves. For this procedure to be equitable, the supervisory agencies would need to coordinate to ensure that they were all using 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 by income nominally due and income actually received from those classes. This would enable investors to judge more accurately 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 information public could be a condition for participation in the other portions of this experiment in a market approach to banking supervision.

Regulatory Cost Reduction

A second approach is that banks that have top CAMEL ratings and that are especially well capitalized—that is, those that exceed by some 20 or 30 percent the thresholds now used by regulators for considering an institution to be well capitalized—could be given some relief from the frequency and intensity of examinations intended to enhance their safety and soundness.[11] Less regulatory oversight is needed to ensure the safety and soundness of especially well-capitalized banks. Indeed, for sufficiently well-capitalized banks, one might ask why there should be *any* safety-and-soundness-oriented regulation.[12]

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the Call Report, which banks are required to file quarterly with their primary regulator.

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

[11]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: 44,886). For definitions of these ratios, see Board of Governors (1989).

[12]After this paper was written, the four federal regulators of banks and thrifts announced

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 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 currently being devised by the regulatory agencies.[13] These approaches would reward good management and strong capitalization while having no deleterious effect on 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 would require legislation, because the FDICIA now mandates annual exams.

The opportunity for gaining 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.

Streamlining Regulatory Procedure

A third opportunity would be to establish a greatly streamlined regulatory procedure for certain bank mergers and acquisitions or for nonbanking activity expansions involving especially well-capitalized, well-run organizations. Such an organization that wanted to acquire

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: 1). One part of that program could be added to the proposals in this paper. That part 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" (Ibid.: 2).

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

another bank or engage in a nonbanking activity that the Federal Reserve Board had already deemed 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 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 have at least a satisfactory CRA rating, and the transaction cannot 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. An 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 the banks were examined for CRA compliance.

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 to 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 (Federal Reserve Board et al. 1989: 13). In this way, issues can be resolved in a more timely and orderly fashion. Moreover, community groups would 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 will not be delayed.

Rewards for Source-of-Strength Commitment

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 simplify the examination of their subsidiary banks, at least to the extent that the holding company's separate capital could support those 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 set at the holding company level rather than at the subsidiary bank level. In addition, banking supervisors could expand the list of nonbanking activities considered permissible for the nonbank subsidiaries of bank holding companies that have given source-of-strength commitments. Finally, supervisory agencies could give such subsidiaries more leeway to engage in securities underwriting and other limited activities by raising to 49 percent (from the current 10 percent) the limit on the share of a separately capitalized subsidiary's revenue that can be derived from that activity without being considered in violation of the prohibition against being "principally engaged" in that activity. Some of this would require changes in legislation.[14]

[14]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: 5). The relevant proposals in the present paper can be viewed as specific procedures that are consistent with that objective.

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 attract capital more easily, 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 prove to 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 advantage 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.

Testing the Market-Forces Approach

I believe that each of these four approaches should be tested by the regulators. That is, I propose that (1) banks be required to release their examination 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) companies with top CAMEL or BOPEC ratings that are especially well capitalized be given relief from some regulatory requirements; (3) 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) 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.

Most of these proposals require no change in legislation. In those cases where a legislative change is required, it would be desirable to have legislation that enables the experiment to go forward and that 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 nationwide 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 the test should be done in a region of the country rather than nationally. A Federal Reserve District would be a logical site. The test should continue for at least three or four 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 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 should 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 should rise relative to those outside the test area, while operating costs should show a relative decline. Especially well-capitalized and well-managed bank holding companies outside the test area will be pressing their banking supervisors to adopt the approaches being used in the test. Also, if this approach to supervision is valuable to customers, there will 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.

Conclusion

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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A Market Perspective on Financial Regulation

Edward J. Kane

I want to salute Jerry Jordan for standing up on behalf of the market approach to banking regulation. The idea of intensifying the exposure of federal banking regulators to rules and timely market discipline has historically found few adherents among the top officials of the Fed.

For federal banking regulators, the watchword has been discretionary flexibility rather than accountability. U.S. financial regulators have prototypically portrayed themselves as vigilant and farsighted public servants who can always be relied upon to use their discretion in the best interests of the "public." Given this utopian party line, market, budgetary, and statutory constraints on the short-run exercise of regulatory discretion are routinely condemned on the grounds that they are bound to cause suboptimal long-run regulatory performance.

In fact, the longstanding decline in banking-industry share of financial activity and losses incurred in state and federal deposit-insurance messes have both been amplified by short-sighted abuse of regulatory discretion. This abuse creates a strong case for placing tighter discipline on banking regulators. The idea is to lessen the painful conflict that now exists between long-run societal and industry interests and the short-run personal and bureaucratic interests of top banking regulators.

To improve long-run regulatory performance, longstanding defects in regulatory incentives must be repaired. At a minimum, this means enhancing the capacity of U.S. labor and financial markets to monitor and discipline the discretionary actions by which elected and appointed officials systematically reward weak clients and punish strong ones.

Jordan's Four-Point Program

Jordan sees that accountability reform must begin with timely disclosure of the information base from which regulators operate. Full and

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immediate disclosure of examination and other regulatory ratings would allow the press, academic researchers, bank creditors, and bank customers to help taxpayers to monitor and discipline regulatory behavior more effectively. For this reason, I have for several years advocated that banks be allowed to post their most recent regulatory ratings underneath each federal deposit-insurance seal that they display in banking offices.

The other three elements in Jordan's program seek to impose mild "action-forcing rules" on regulators, rules formulated to be conditional on the information being disclosed. The second and third items in his program would constrain regulator discretion by explicitly requiring that high-rated institutions receive less-burdensome supervisory monitoring and enjoy specific regulatory privileges. Jordan proposes to grant strong banks expedited reviews of their requests for new powers and for changes in organizational structure.

The final element in his program would offer privileges to strongly capitalized bank holding companies that voluntarily make a binding pledge to adhere to the source-of-strength doctrine that in the past the Fed has sought inquisition-like to force upon the industry.

The Market for Financial Regulatory Services

Financial regulation is a service that clients value for the benefits of confidence and convenience that it confers on customers who use the client's products. The failure of the Fed's source-of-strength doctrine to win converts in the absence of a quid pro quo for adherents illustrates the nature of transactions that occur in the market for regulatory services. In this market, the Fed is only one of many domestic and foreign suppliers.

Although the policy literature speaks of regulatory "requirements," this word is a misnomer. Regulators do not and cannot autonomously "command and control" the behavior of the client institutions they regulate. Rather, each regulator's "controls" are shaped by prior conditioning and ex post feedback from the parties it regulates. To survive, a control must be voluntarily accepted by regulatees in the long run. Unacceptable controls lead regulatees and their competitors to engage in "regulatory arbitrage" that effectively transfers market share from inefficient to efficient suppliers of regulation.

The long-run voluntariness of regulatory relationships underscores the parallels that exist between operating a regulatory agency and operating an ordinary business. To succeed in the long run, each regulatory enterprise must deliver a quality product at a fair price.

The equivalent of the price of a regulatory system is the net burden it places on its regulatees. This net burden differs from the "gross burden" of regulation in two ways. First, it subtracts out the benefits in customer confidence and transactional efficiency that a regulator confers on its regulatees. Second, it further eliminates any costs of operating the regulatory system that can be successfully shifted to unwary taxpayers.

As a price, each regulator's net burden responds over time to opportunities for substitution. Competition from differentially regulated institutions and other market forces lead regulated parties to do two things: (1) to lobby for less-burdensome rules, and (2) to adapt their economic strategy and organizational form to reduce the opportunity costs that the regulation would create for their firms if managers were to comply with existing rules mindlessly. For this reason, the cost of inefficient regulation tends over time to shift from costs of strict "compliance" to costs of regulatory arbitrage. The cost of regulatory arbitrage is the cost of adapting a regulatee's product line, production and distribution systems, business locations, and corporate structure to make it legally possible to engage in profitable activities from which the firm would otherwise be excluded.

Interstate banking exists, even though interstate branching remains limited. A bank's holding-company affiliates engage in many activities from which banks themselves are legally excluded. The advantage of relaxing for strong banks what are outmoded restrictions on locations and activities and routinizing administrative reviews of structural-arbitrage proposals is that this would eliminate some economically inefficient bank expense. But it does not promise to optimize the burden placed on strong banks.

Wisdom of Relaxing the Net Burden for Strong Banks Only

Between 1950 and mid–1992, the share of U.S. financial assets held by domestically chartered banks shrunk from 50.5 to 20.4 percent (Barth and Brumbaugh 1993). This decline is due partly to expansion in bank off-balance-sheet activity, but also to changes in information technology that open up bank markets to foreign and cross-industry domestic competition and inefficiencies in federal banking regulation.

Net regulatory burdens differ drastically between strong and weak U.S. banks. Weak banks receive subsidies from deposit insurance that strong banks eventually help to pay for. The net burden of strong banks has increased secularly in two respects. First, social-purpose regulation (whose benefits are directed outside the industry) has generated an increasing paperwork burden. Second, regulatory efforts to retard the exit of inefficient and insolvent deposit institutions lower the profit margins strong firms can earn and push their deposit-insurance premiums above the value of the guarantee services these low-risk institutions receive.

In explicitly seeking to lower the net regulatory burden for strong banks, Jordan's program takes an important step. However, it does not specifically seek to equalize the net regulatory burden for strong U.S. banks with that of competing financial-services firms or to equate the part of the burden banks shift to taxpayers with the benefits of the social responsibilities banks are asked to shoulder. One way or another, the law of one price tells us that market pressures on U.S. banks and banking regulators will accomplish both types of equalization in the long run. The question is how much of U.S. bank's financial-market share will have to be transferred to foreign firms and domestic nonbank financial institutions in the meantime.

A Four-Part Program of Market-Based Regulatory Reform

Like Jordan, I have a four-part program for regulatory reform. It also combines requirements for information disclosure with action-forcing rules. My approach to information reform recognizes that a central task of most bureaucracies is to cover up emerging evidence of mistakes. It is necessary to increase the timeliness and accuracy of information supplied by managers of insured institutions, managers of deposit insurance funds, and politicians to reduce opportunities for administrative coverups of accruing losses. So that markets can discipline managerial mistakes in timely fashion, I would make it a legal duty for regulators to report taxpayers' loss exposure in their enterprise. I recommend the adoption of self-reporting and market-value accounting principles for measuring periodic performance and taxpayer loss exposure at all regulated firms and regulatory agencies. As with the reporting requirements citizens face under the federal income tax, I would enforce these principles by establishing civil and even criminal penalties for managers who could be shown at any time to have willfully provided less than their best estimate of their enterprise's market value and loss exposure.

To reduce the scope for regulators to retard the exit of inefficient and insolvent institutions, I would institute three types of action-forcing rules. These rules would specify what is meant by a regulator's duty of faithfulness to taxpayers and establish mechanisms that would penalize derelictions of this duty.

The first rule would require FDIC managers to recapitalize their insurance funds promptly (i.e., according to a prespecified time table) whenever the market value of their enterprise's net reserves falls below a specified minimum. In this way, deposit-insurance losses would be passed through the federal budget as they accrue.

Second, I would lessen the advantages of political incumbency by strengthening electoral challenges of unsatisfactory performers. I would do this by requiring that fifty cents of every dollar in campaign contributions that is raised by an incumbent member of Congress be paid into a party-administered fund used to finance candidates running against incumbents of the opposite party. This would strengthen party discipline, enable new members of Congress to take office without establishing a prior debt to special interests, and shorten the careers of dishonest politicians who would find it hard not to violate this law.

Finally, I would require members of Congress and the administration to acquiesce in three additional requirements: (1) to set explicit limits on their ability to intervene ethically into the process of closing individual institutions; (2) to report all such interventions to congressional banking and ethics committees for explicit review; and (3) to subject committee reviews and regulatory-agency performance accounting to regular evaluation by "disinterested" outside experts.

The prospective difficulty of enacting these reforms is a measure of the depth and stubbornness of incentive defects in banking regulation today. Before they can become desirable to officials, the value of these reforms will have to be appreciated by the electorate. The root incentive defect in representative democracy today is the disincentive for ordinary citizens to go to the trouble of understanding the high long-run costs that their elected and appointed representatives create as they pursue fleeting, short-run benefits.

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