The Safe Way to Give Traditional Banks Regulatory Relief

Thomas M. Hoenig
June 22, 2015
American Banker

There is broad agreement that regulatory relief should be provided to community banks. While easing their burden is a legitimate goal, achieving it has proven elusive. Reformers have struggled to determine safe and practical ways to provide meaningful relief that will not compromise the necessary strengthening of rules for large, complex financial institutions and overall financial stability.

Regulatory relief for traditional banks can be achieved. However, to do so requires an objective set of criteria that would establish eligibility while maintaining safety and soundness.

I propose the following plan. A bank would be eligible for regulatory relief if:

- It holds no trading assets or liabilities
- It holds no derivative positions other than interest rate and foreign exchange derivatives
- The total notional value of all its derivatives exposures — including cleared and non-cleared derivatives — is less than $3 billion
- It maintains a ratio of Generally Accepted Accounting Principles equity-to-assets of at least 10%

Defining eligibility for regulatory relief around these specific criteria reflects the longstanding business models of traditional commercial banks. And because these criteria are objective, they can be enforced with less of an imposition on the banks through off-site call report monitoring and the regular exam process.

More than 90% of the approximately 6,400 commercial banks in our country meet the first three criteria, and two-thirds of them meet the fourth criterion regarding capital. The remaining one-third of these banks are within two percentage points of the capital requirement and could be afforded relief by demonstrating good progress over a 24-month period toward reaching the minimum capital standard.

Among banks that would qualify are 18 regional banks — one with assets exceeding $104 billion — that maintain the more traditional banking model. Given meaningful regulatory relief, I expect many other regional banks, which are already close to meeting these thresholds, would choose to follow suit.

Importantly, size does not limit eligibility for regulatory relief using this metric. An insured bank of any size would qualify if it does not expand into activities that are associated with commercial and investment banks, insurance companies, or commercial or industrial firms. The effect is to

keep nonbank activities outside the insured bank, where they are directly subsidized by the taxpayer and create unstable economic distortions. This issue contributed significantly to the recent financial crisis and invited passage of the Dodd-Frank Act.

A small number of banks — including regional and community banks — have investment bank-like activities supported by the safety net. They would therefore not meet these criteria and, appropriately, would not qualify for regulatory relief. That is by design. An insured bank of any size that chooses to engage in extended activities must play by extended rules.

With this framework, then, we can outline meaningful regulatory relief for those more traditional banks that is consistent with safety and soundness and would benefit not only these banks but the American public. They include:

- Exempting these more traditional banks from all Basel capital standards and associated capital amount calculations and risk-weighted asset calculations.
- Exempting these banks from several entire schedules on the call report, including schedules related to trading assets and liabilities, regulatory capital requirement calculations, and derivatives.
- 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.
- Establishing further criteria that would exempt eligible banks from appraisal requirements
- Exempting banks, if applicable, from stress testing requirements.
- Where judged appropriate, allowing for an 18-month examination cycle as opposed to the current required 12-month cycle for traditional banks.
- Mortgages made by these traditional banks that remain in the banks' portfolio would be a qualified mortgage loan for purposes of Dodd-Frank Act.

This proposal, however, would not repeal reforms judged necessary to curb the excesses of the most complex banks that have used the federal safety net to expand into areas well beyond traditional banking at a debilitating cost to the American public.

U.S. banks engaged in core banking activities and operating with reasonable levels of capital should not incur the same regulatory burden as those that do not. Nor should traditional bankers seeking measurable regulatory relief consistent with their business models be held hostage to debate over Dodd-Frank requirements that appropriately apply to firms that adopt a commercial and investment banking business model. The approach I suggest would allow traditional banks to continue providing credit to small businesses and consumers across the country without the artificial restraints created by misdirected regulations.

Thomas M. Hoenig is vice chairman of the Federal Deposit Insurance Corp.