

**A Conversation about Regulatory Relief and the Community Bank: Remarks by FDIC Vice Chairman Thomas Hoenig, presented to the 24th Annual Hyman P. Minsky Conference, National Press Club, Washington, DC
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Introduction

I have always found it insightful that Senator Richard Shelby, at confirmation hearings for bank regulatory posts, often asks the nominees if they know of any failed bank that was well capitalized, well managed, and well supervised. The answer is always wisely “no.”

As the effects of the financial crisis of 2008 are receding, this is a useful question for all policymakers to contemplate as they consider issues of regulatory burden and relief. Reducing unnecessary regulatory burden is a legitimate goal. However, such relief can only follow if we are confident in the durability of the financial industry.

In my remarks this morning I will share my perspective on what led to the regulatory burden from which the industry is now seeking relief. I will suggest a set of criteria that would strengthen the industry’s case for such relief, which will emphasize the importance of strong equity capital and the core commercial banking model. Finally, I will suggest that regulatory relief for the community bank should not be given as a reason for abandoning the Volcker Rule.

Regulatory Landscape

In addressing the issue of regulatory burden, it is important to recognize that by necessity, the largest, most systemically important banks have had access to the safety net for decades, as they conduct intermediation and operate the payments system. However, more recently they have been permitted to engage in extended activities previously reserved for investment banks, insurance companies, commercial and industrial firms, and other types of businesses. When these activities take place inside a bank, they are directly subsidized by the taxpayer. This situation has shown itself to be unstable, contributing to the financial crisis and leading to the Dodd-Frank Act.

To be clear, I am not a critic of these activities, all of which are important components of the financial system. My concern lies with the distortions to the financial system that follow when these activities are conducted by commercial banks, resulting in creditors becoming protected and markets no longer disciplining firms’ behavior. The public subsidy allows the commercial bank that engages in this extended set of activities to obtain funding on favorable terms, operate with less capital demanded by creditors, and profit from the upside of investments while pushing the downside onto the taxpayer.

To illustrate this point, a colleague and I at the FDIC have constructed the Global Capital Index (Index)¹, which shows the tangible capital levels for each of the largest global banking firms and the average levels for different size groups of US banks. The Index shows that the largest global banks -- those with the broadest range of activities beyond traditional commercial banking -- hold the least amount of capital of any group of banks. In other words, management has chosen to retain a business model in which the firms engage in expanded trading and related on- and off-balance sheet activities subsidized by government backstops. For example, Column 8 of the Index shows that when balance sheet assets and off-balance sheet activities are fully accounted for under international accounting standards, the largest firms on average hold less than 5 cents of capital for every dollar of assets held. This is not safe; it invites uncertainty when the system is under stress and undermines financial stability. It is hard to justify regulatory relief for the handful of such firms when too little is different today than in 2007.

However, the Index also illustrates that at the more than 6,500 other commercial banks in the United States, capital levels far exceed those of the largest firms. The average capital positions held by the remainder of the industry, shown in the last three rows of the Index, are much stronger. For example, the largest non G-SIBs have tangible capital exceeding 8 percent, a level similar to other smaller bank groups listed. There is, from a capital perspective, a case to be made for regulatory relief for the vast majority of commercial banks.

A Proposal for Discussion

With this in mind, I suggest focusing the regulatory relief discussion on activity and complexity, not strictly size. As such, I suggest defining eligibility for regulatory relief around the following criteria:

- banks that hold, effectively, zero trading assets or liabilities;
- banks that hold no derivative positions other than interest rate swaps and foreign exchange derivatives; and
- banks whose total notional value of all their derivatives exposures – including cleared and non-cleared derivatives – is less than \$3 billion.

Such banks are consistently better capitalized than less traditional banks, as the Global Capital Index shows, and they have a lower rate of failing or requiring government assistance, as shown in Chart 1.

¹ Global Capital Index: <https://www.fdic.gov/about/learn/board/hoenig/capitalizationratios4q14.pdf>

Of the more than 6,500 commercial banks, only about 400 do not meet these three criteria. None of the banks with more than \$100 billion in total assets meet these criteria; and only 90 of the more than 4,000 banks with less than \$250 million in total assets fail to meet these criteria.

The right level of capital is a discussion worth having. I suggest opening the conversation by recommending a fourth criterion to be eligible for regulatory relief: a bank should have a ratio of GAAP equity-to-assets of at least 10 percent. The substantial majority of community banks already have equity-to-asset ratios of 10 percent or higher, and the number is in reach for those that do not.

Once conditions for eligibility are established, the dialogue with community banks could turn to areas that they consistently highlight as sources of regulatory burden. These areas include:

- the new risk-based capital rules,
- an ever-expanding Call Report, many fields of which aren't relevant for traditional banks,
- some elements of consumer compliance regulation,
- appraisal requirements, and
- the frequency of the examination cycle.

Given that activities of the more traditional banks pose less risk to the public, I suggest that meaningful regulatory relief for traditional banks – those that meet the criteria above – can be provided in a manner that is entirely consistent with safety and soundness. Such relief could include:

- Exempting traditional banks from all Basel capital standards and associated capital amount calculations and risk-weighted asset calculations.
- Exempting such 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 examiner judgment and eliminating requirements to refer “all possible or apparent fair lending violations to Justice” if judged to be de-minimis or inadvertent.
- Establishing criteria that would exempt traditional banks from appraisal requirements.²

² Research would be required to determine the exemption criteria based on an appropriate number or dollar threshold of loans against real estate collateral.

- Exempting traditional banks, if applicable, from stress testing requirements under section 165(i)(2) of the Dodd-Frank Act.
- Where judged appropriate, allowing for an 18-month examination cycle as opposed to the current required 12-month cycle for traditional banks.

Volcker Rule Exemptions

Finally, on this list you will not find a recommendation to exempt traditional banks from the Volcker Rule as some have suggested, even for community banks. The Volcker Rule represents a modest step toward limiting insured banks from proprietary trading in derivatives, thus moderating the incentives for speculation with subsidized funding from the FDIC and the Federal Reserve using insured deposits and ready access to central bank liquidity. Weakening the Volcker Rule would be contrary to moving the largest financial firms toward self-sufficiency; where they can return to serving as a shock absorber rather than as an amplifier for shocks to the economy, as they were in the last financial crisis and remain today.

Some say that the Volcker Rule poses onerous and costly operational compliance burdens on community banks. The reality is that the vast majority of community banks have virtually no compliance burden associated with implementing the Volcker Rule. Not only do these banks not have proprietary trading operations, but they generally have no trading positions of any kind. In addition, community banks do not invest in any private-label securitizations, let alone more complicated hedge funds or private equity funds.

I cannot state more directly, as existing guidance³ already details, that community banks with less than \$10 billion in total assets are already exempt from all of the Volcker Rule compliance requirements if they do not engage in any of the covered activities other than trading in certain government, agency, state, and municipal obligations. This is the case for most community banks.

For community banks which are receiving conflicting information from consultants, regulators should clarify or expand the current guidance to eliminate the confusion.

For the banks under \$10 billion that do engage in traditional hedging activities, existing guidance should be updated to clarify that Volcker Rule compliance requirements can be met by simply having clear policies and procedures that place appropriate controls on the activities -- and which are required regardless of the Volcker Rule. The existence and appropriateness of such policies and procedures can be verified by examiners as part of the regular exam process, and would not require extra compliance assistance from consultants.

³ Volcker Rule guidance for banks with less than \$10 billion of assets:
<https://www.fdic.gov/regulations/reform/volcker/summary.html>

Finally, some banks under \$10 billion do engage in less-traditional activities that may be restricted by the Volcker Rule. For these banks, there would be some initial compliance requirements to determine their status. These banks represent less than 400 of a total of approximately 6,500 smaller banks in the US. And of these 400, most will find that their trading-like activities are already exempt from the Volcker Rule. If the remainder of these banks have the expertise to engage in complex trading, they should also have the expertise to comply with Volcker Rule.

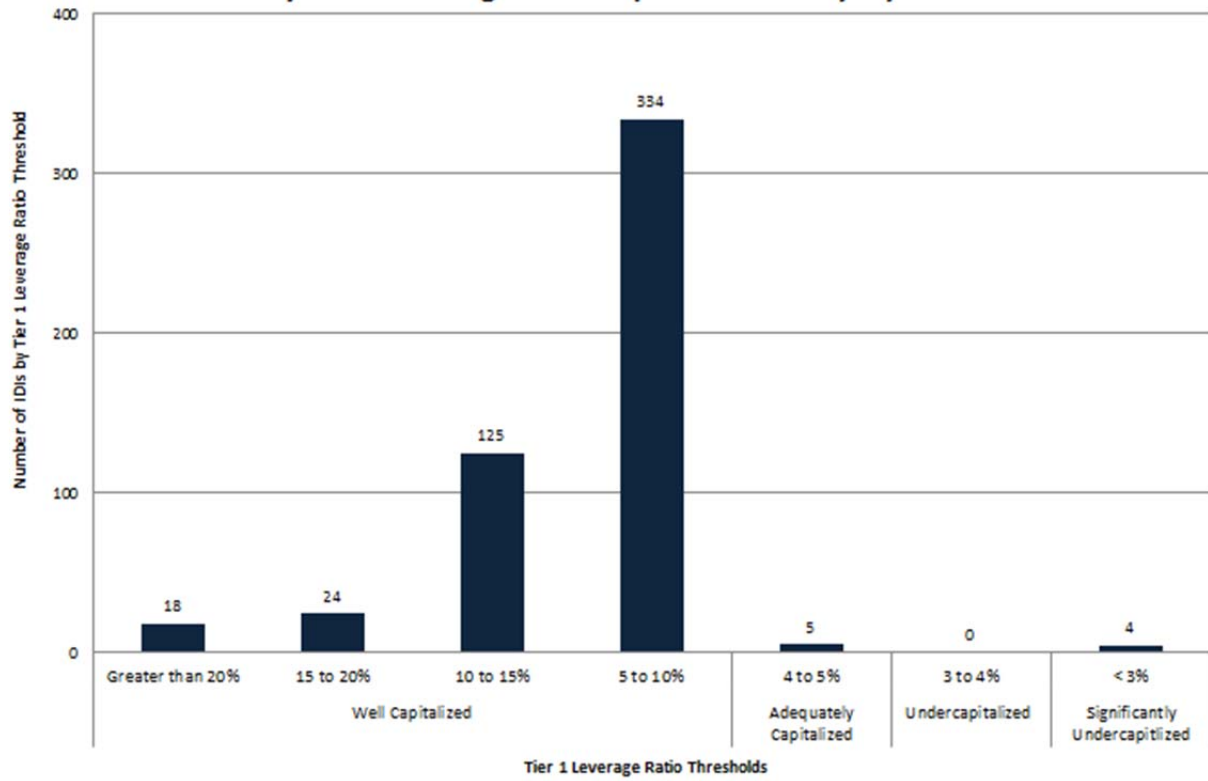
On balance, therefore, a blanket exemption for smaller institutions to engage in proprietary trading and yet be exempt from the Volcker Rule is unwise. A blanket exemption would provide no meaningful regulatory burden relief for the vast majority of community banks that do not engage at all in the activities that the Volcker Rule restricts. However, a blanket exemption for this subset of banks would invite the group to use taxpayer subsidized funds to engage in proprietary trading and investment activities that should be conducted in the marketplace, outside of the safety net.

Conclusion

Defining an approach to regulatory relief by complexity and activity, not strictly size, would provide a beneficial and prudent trade-off for firms protected by the safety net by acknowledging that banks that engage in traditional banking activities are sufficiently supervised and by appropriately bringing riskier activities under greater scrutiny.

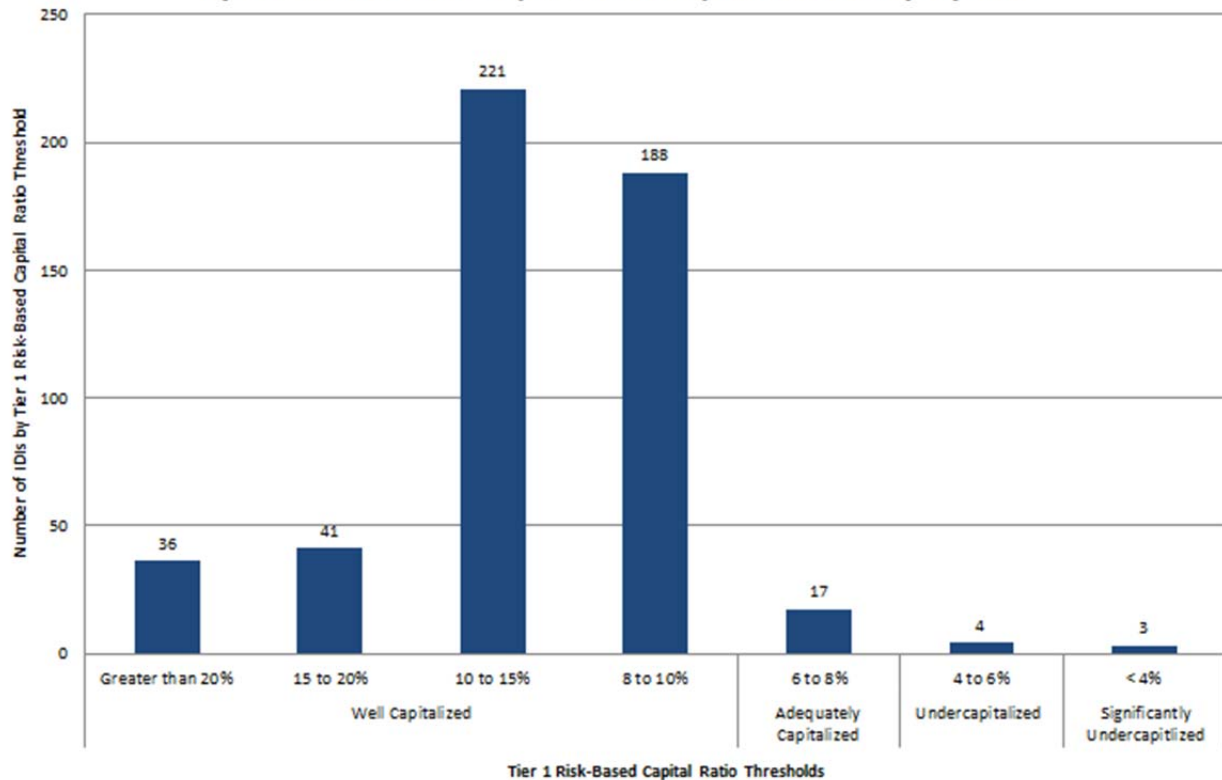
For the vast majority of commercial banks that stick to traditional banking activities, and conduct their activities in a safe and sound manner with sufficient capital reserves, the regulatory burden should be eased. For the small handful of firms that have elected to expand their activities beyond commercial banking, supported with the subsidies that arise from the bank's access to the safety net, the additional regulatory burden is theirs to bear.

**CHART 1: 510 Insured Depository Institutions that have failed since 2008
by Tier 1 Leverage Ratio Reported as of 12/31/2007**



Source: FDIC Call Report Data as of 12/31/2007

**CHART 2: 510 Insured Depository Institutions that have failed since 2008
by Tier 1 Risk-Based Capital Ratio Reported as of 12/31/2007**



Source: FDIC Call Report Data as of 12/31/2007

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

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