Statement of
Thomas M. Hoenig,
Vice Chairman of the Federal Deposit Insurance Corporation
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The Economic Growth and Regulatory Paperwork Reduction Act
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Thank you for joining us to discuss regulatory relief, or, as the process is officially called, the Economic Growth and Regulatory Paperwork Reduction Act. This process is designed to identify unnecessary or outdated regulations. The ideas we will share today are particularly timely as lawmakers in Washington debate various approaches to relief and, importantly, various approaches to determining what type of banks are eligible for relief.

I think it is fair to say there is broad agreement that the regulatory burden should be eased for community banks. However, what is proving more difficult is finding agreement on what exactly defines a traditional bank and what specific regulatory changes would give such banks meaningful relief without compromising bank soundness or consumer protections.

As some of you know, I have spent my career in the weeds of bank supervision; in fact I spent the bulk of my career right here at the Federal Reserve Bank of Kansas City supervising banks of all sizes throughout the region. What my experience tells me is consistent with what I hear from many community bankers. They judge that the regulations and supervisory requirements that burden them should not be the same as those that apply to complex institutions that do both trading and traditional commercial banking. To be blunt, that is not the message we hear in Washington from lobbyists who represent banks with a variety of business models, or the message you hear from consultants selling advise.[i]

Providing meaningful regulatory relief for banks engaged in the basics of commercial banking, while maintaining a safe and sound financial system, requires focusing the discussion more on bank activity and complexity, and less on size.

With that in mind, I have recommended that we establish an objective set of criteria for eligibility for relief that emphasizes the core commercial banking model and the importance of strong equity capital.

Under the 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, rather than asset size, 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, using off-site call report monitoring and within the regular exam process.

More than 90 percent 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 as they achieve this objective over a 24-month period.

It is worth noting that among banks that would qualify are 18 regional banks - one with assets exceeding $104 billion. Given meaningful regulatory relief, many other regional banks, which are already close to meeting these thresholds, could 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.

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 also the American public. They include, for example:

- Exempting these more traditional banks from all Basel capital standards and associated risk-weighted asset calculations.
    - In addition to drastically simplifying the calculation of capital requirements, such an exemption would address other specific issues related to Basel III for community banks including mortgage service rights, capital buffers for banks registered as S-Corporations, high-volatility commercial real estate, and various securitizations products.
- 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.
- 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.
- Updating existing guidance 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 and currently verified by examiners regardless of the Volcker Rule.

This proposal would not extend to reforms judged necessary for the most complex banks that have used the federal safety net to expand into areas well beyond traditional banking, and as recently experienced, 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 be held hostage to debate over Dodd-Frank requirements that apply to firms that choose to engage is a much broader set of investment banking and commercial activities. The public needs commercial banks to provide credit to small businesses and consumers across the country without the burdensome constraints of misdirected regulation.

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[i] The Volcker Rule is one example. The vast majority of community banks have virtually no compliance burden associated with implementing the Volcker Rule because they have no trading positions of any kind, including no proprietary trading operations and no investments in any private-label securitizations, hedge funds or private equity funds. As existing guidance details, 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 that are receiving conflicting information from consultants, regulators should clarify or expand the current guidance to eliminate the confusion.