Today I will discuss bank regulation and supervision from a cost-benefit perspective, focusing on how the Federal Reserve and our fellow bank regulators take benefits and costs into account when we develop rules and supervisory policies. As you know, the Federal Reserve's regulatory powers and responsibilities derive ultimately from statutes passed by the Congress and signed by the President. Historically, the goals of banking regulation have included the safety and soundness of bank operations, the stability of the broader financial system, the promotion of competition and efficiency in banking, assistance to law enforcement, consumer protection, and broader social objectives. Whatever the motivation, once the Congress decides that a particular issue must be addressed, it typically (though not always) gives the federal banking agencies significant discretion to devise the regulations and supervisory policies that implement the statute. Often, the agencies collaborate in developing rules, and we rely heavily on input from the public received both through formal requests for comment and through other channels, such as consultations with industry or consumer groups.

In setting regulatory and supervisory policy, we are first concerned with ensuring that the rules reflect the intent of the Congress. We also seek to implement the will of Congress in a manner that provides the greatest benefit at the lowest cost to society as a whole. Perhaps I should emphasize the phrase "society as a whole." We are ever mindful that banks and their customers bear a large share of the costs of regulation. Minimizing the regulatory burden on banks is very important. But other parts of society, besides enjoying some of the benefits of regulation, also share some of the costs, both direct and indirect. Making good regulatory policy requires that we take a broad view of the way our rules affect our economy and our society, while maintaining a suitable degree of humility about our ability to accurately quantify the relevant benefits and costs.

In the rest of my remarks, I will briefly illustrate how the Federal Reserve, along with the other federal banking agencies, applies these principles in three major areas of bank regulation and supervision: the Bank Secrecy Act, bank capital standards, and the Community Reinvestment Act. Finally, I will highlight some elements of the Regulatory Relief Act, which the Congress passed this year. Periodically the Congress reviews the federal banking laws to determine if the costs imposed by some laws are no longer justified by the associated benefits, and this act is its latest effort in this area. The Federal Reserve supported and actively contributed to the development of this legislation.

The Bank Secrecy Act

The prevention and detection of the criminal misuse of the financial system, including threats to national security such as the financing of terrorist activities, are among the highest of public policy priorities. The primary goal of the Bank Secrecy Act (BSA), passed by the Congress in 1970, is to help deter, detect, and investigate money laundering and other financial crimes, including terrorist financing. As you know, this act gives U.S. banking institutions the responsibility to obtain sufficient customer information to detect and report suspicious activity.

The potential benefits of the information obtained through the BSA are large, but implementation of the act should not ignore other public policy considerations, including the need to maintain a reasonable expectation of financial privacy for legitimate bank customers and to ensure that reporting requirements do not unduly impede the efficient operation of the payments system. The principal concern about the BSA that we hear from the banking industry, of course, is the cost of compliance. The Federal Reserve recognizes that the provisions of the BSA require considerable effort by banks to obtain, document, and provide the required information. Deterring and identifying misuse of the financial system, as important as that is, should not be so onerous that it stifles innovation, interferes with the critical economic functions of financial intermediaries, places undue burden on bank shareholders and customers, or reduces the international competitiveness of U.S. banks. To address
these important concerns, the Federal Reserve has worked and will continue to work closely with the other federal banking agencies and the Treasury Department's Financial Crimes Enforcement Network (FinCEN), the administrator of the BSA, to look for ways to streamline the reporting processes created by the BSA without diminishing the value to law enforcement of the information produced.

The regulatory burden of the BSA is also affected by supervisory policy. From a supervisory perspective, I see at least three areas in which progress could be made in reducing the burden on banks. First, the industry should have the opportunity to receive feedback about the usefulness of reporting suspicious activity as well as guidance about how better to identify the most significant risks. Some useful steps have been taken. For example, FinCEN's publication, The SAR Activity Review, includes aggregate information and case studies about suspicious activity report (SAR) filings and use, and law enforcement representatives have undertaken outreach efforts to communicate to the financial services industry the importance of BSA reports in investigations and prosecutions. Efforts to further increase feedback would help banks allocate their compliance resources more efficiently while complying with the act and preventing misuse of the financial system.

Second, the banking industry should have effective channels for voicing concerns about burden or about lack of clarity regarding regulatory standards and supervisory expectations. One such channel is the Bank Secrecy Act Advisory Group, created by the Congress, which includes representatives from government and the financial services industry. In particular, the examination subcommittee of the advisory group can serve as a conduit for the industry to raise issues of supervisory concern. The Federal Reserve will continue to seek industry input through a variety of channels, including meetings with banking groups and as part of the supervisory process itself.

Third, supervisors should continue to work to improve the consistency of their approach to compliance and to ensure that adequate guidance is provided to assist banks in the assessment and management of risks. The release of the Bank Secrecy Act/Anti-Money Laundering Examination Manual in June 2005 was, I believe, an important step in that direction. The five federal banking agencies in collaboration with FinCEN developed the manual, with input from state banking agencies and the Office of Foreign Assets Control. The manual, which was revised this year, emphasizes that supervision of compliance efforts should be risk-based; that is, supervisors should focus on banks' policies and procedures, not on isolated incidents, with particular attention to the areas in which the most serious problems might arise. In a difficult area like this one, it is also particularly important that supervisors be flexible, using good judgment and a collaborative approach to help banks achieve the objectives of the act. Your feedback on the manual and on the related supervisory procedures is welcome.

Bank capital standards

Bank capital standards provide a second illustration of our efforts to balance the benefits and costs of regulation and supervision. Capital regulation is the cornerstone of bank regulators' efforts to maintain a safe and sound banking system, a critical element of overall financial stability. For example, supervisory policies regarding prompt corrective action are linked to a bank's leverage and risk-based capital ratios. Moreover, a strong capital base significantly reduces the moral hazard risks associated with the extension of the federal safety net.

The banking regulators broadly agree that the current risk-based capital regime, known as Basel I, is inadequate for the largest and most complex banking organizations. For this reason, in 2004, all the U.S. banking agencies joined other members of the Basel Committee on Banking Supervision in supporting a new international capital adequacy framework, called Basel II. Basel II capital requirements will be much more risk-sensitive than those in Basel I and will provide stronger incentives for institutions to improve the measurement and management of risk. Basel II will also give supervisors a better framework for evaluating the adequacy of a bank's capital buffer above the regulatory minimums and should improve market discipline by providing financial markets with better information on banks' risk-taking.

The U.S. banking agencies recently asked for public comment on a Notice of Proposed Rulemaking (NPR) for implementing the Basel II advanced approaches in the United States. In developing this proposal, our paramount concern has been ensuring the safety and soundness of the U.S. banking system. This concern can be seen, for example, in the proposal's transitional safeguards, which go beyond those in the 2004 Basel Committee text by providing greater protection against unintended declines in minimum capital requirements during the initial years of Basel II implementation.
At the same time, we have tried to reduce regulatory burdens in several ways. In particular, the advanced elements of Basel II are intended to apply only to the very largest and most internationally active U.S. banking organizations, not to the great majority of U.S. banks. For banks not adopting Basel II, the agencies have been developing a modernized but easier-to-implement capital framework, known as Basel IA. Under Basel IA, the capital treatments for certain activities will be more risk-sensitive than those under Basel I, thus better aligning the treatments with those in Basel II. The NPR for Basel IA should be issued soon. Some bankers have suggested that Basel I may still be suitable for many small banks and that, consequently, they should have the option of whether to move to Basel IA. We will consider this possibility carefully.

We have also been working to promote a level playing field internationally for U.S. banking organizations that adopt Basel II. Indeed, maintaining competitive equity was one of our key motivations for developing Basel II jointly with foreign supervisors through the Basel Committee. More recently, we have been working through the Basel Committee's Accord Implementation Group to mitigate home-host conflicts while promoting consistent implementation of Basel II internationally.

Despite these efforts, some significant differences do exist between the United States and other countries in the proposed implementation of Basel II's advanced approaches, beyond the transitional safeguards. Early comments on the Basel II NPR suggest that, whatever the merits of these international differences in rules, they are likely to add to implementation costs and home-host issues, particularly for globally active banks operating in multiple jurisdictions. Before we issue a final rule, we intend to review all international differences to assess whether the benefits of rules specific to the United States outweigh the costs. In particular, we will look carefully at differences in the implementation of Basel II that may adversely affect the international competitiveness of U.S. banks.

Many other opportunities may exist to reduce the burden of the new capital regulations. Public comments will be critical in shaping the final rules, and we will look to banking organizations for help in identifying aspects of the NPR that would impose competitive inequities or undue costs. I am confident that, working together, we can do more to level the competitive landscape and reduce burden without compromising our primary objective of maintaining the stability of the U.S. banking and financial system.

Community Reinvestment Act

I now want to shift from the role of bank regulation and supervision in the national and global context and discuss one aspect of its place in local markets. Clearly, banks strengthen their local communities by providing a range of services and facilitating the flow of credit necessary to support economic development. However, economic development in some communities, particularly lower-income communities, may be hampered by what economists call "market failures." For example, if information about economic opportunities is particularly costly to obtain in lower-income neighborhoods, then potentially profitable loans and investments may not get made. Another form of market failure may arise because of so-called neighborhood effects: Because the values of homes and businesses are affected by the overall economic vitality of the neighborhood in which they are located, the returns to an individual bank's investments in a given area may depend on whether other banks are investing in that area as well. But if no bank is willing to go first, so to speak, the neighborhood may be underserved and potentially profitable opportunities may be missed.

To address these possible market failures, to ensure that depository institutions help to meet the credit needs of their communities, and to achieve broader social goals such as expanding home ownership, the Congress in 1977 passed the Community Reinvestment Act (CRA). A key goal of the CRA is to induce banking institutions to invest in acquiring the knowledge and expertise needed to find profitable lending opportunities in lower-income neighborhoods, thereby removing an important barrier to the extension of credit in those neighborhoods. Likewise, to the extent that the CRA leads a number of banks to provide credit and services to an underserved area, the returns to each bank's investments in that neighborhood should improve, reducing the "first mover" problem. Indeed, many banks have found that lending and investment in lower-income neighborhoods can be profitable, which has led them to expand their activities in those areas.

As you know, the CRA requires that each banking institution's record of serving lower-income areas be regularly evaluated and that these ratings be made public. The Congress has given the banking agencies substantial discretion to determine the methods by which they assign CRA ratings. As experience with the CRA has accumulated and as the economic environment has changed, the
agencies, with the benefit of public input, have exercised that discretion with an eye toward both increasing the effectiveness of the act and reducing its costs. For example, the early CRA rules emphasized process over performance, and major changes were made to the regulations in 1995 to make the CRA evaluations more oriented toward performance. These changes increased reporting burdens for some institutions, as the new rules required them to collect and submit data concerning their lending performance. In the judgment of the agencies, the broader social benefits of a more-quantitative, performance-based method of assigning CRA ratings justified the increase in regulatory burden. However, aware of that burden, the agencies exempted the smallest community banks and thrifts from the data-reporting requirement and allowed them to undergo streamlined evaluations of their retail lending and services.

Beginning in 2001, the agencies revisited the issue, undertaking a careful review of the benefits and costs of the data-reporting requirements applied to non-exempt community banks and thrifts, as well as the associated rules that determined eligibility for streamlined CRA evaluations. As part of this effort, members of the Federal Reserve Board staff published a study comparing the retail lending and services of community banks and thrifts eligible for streamlined evaluations and exempt from data reporting with the activities of comparable institutions without those exemptions (Avery and others, 2005). The analysis suggested that exempting a larger number of relatively small institutions from the more onerous requirements would not adversely affect the provision of retail lending or services in lower-income communities. Consistent with that analysis, in 2005 the agencies substantially increased the number of community banks and thrifts eligible for streamlined evaluation and exempt from the data-reporting requirement. At the same time, the agencies also addressed several concerns about the effectiveness of CRA regulations in encouraging these institutions to invest in community development. Among the concerns expressed was that the method for evaluating the community development records of larger community banks and thrifts was inflexible and produced unintended costs. After reviewing public input and the available evidence on the costs and benefits of the current process, the agencies adopted a new evaluation method that considers all of the community development activities of such institutions under one test. Although we recognize that this change is very recent, we welcome feedback on how well it is working for financial institutions and communities alike.

Regulatory relief

My focus thus far has been on how the Federal Reserve and the other banking agencies develop regulatory and supervisory approaches to implement the applicable laws. But regulatory agencies may also play a role in the legislative process itself, for example by raising issues that may require legislative remedy, commenting on proposed legislation, and providing technical assistance in the drafting of bills. Our extensive practical experience in implementing legislation makes us particularly well placed to advise the Congress when legislation is not achieving its intent or is imposing costs on banks or on society that exceed its benefits.

In this regard, I am pleased that Congress recently passed, and the President signed, the Financial Services Regulatory Relief Act of 2006. Certainly, the act does not address every concern that banks and regulators have raised about regulatory burden, and I hope that the Congress will continue to revisit these issues. But the legislation does include a number of provisions that, when implemented, should provide substantial relief to banking organizations and increase efficiency in the banking system while enhancing the Federal Reserve's tools for conducting monetary policy.

Among the act's most important provisions are two that relate to reserve requirements. Federal law currently obliges the Board to establish reserve requirements on transaction accounts and prohibits the Board from setting these reserve requirements below 8 percent for amounts above the so-called low-reserve tranche. Because the Federal Reserve is not permitted to pay interest on the balances held at Reserve Banks to meet reserve requirements, depositories have an incentive to reduce their required reserve balances to a minimum. Institutions use various techniques to minimize required reserves, such as sweep programs that move funds between deposit accounts subject to reserve requirements and money market accounts not subject to those requirements. From the perspective of society as a whole, sweep programs have little or no economic value to justify their cost of implementation.

The Regulatory Relief Act will allow the Federal Reserve to pay depository institutions interest on the balances held to meet reserve requirements; it also gives the Board the discretion to lower the ratio of required reserves to transaction accounts. The Board has long sought these amendments, which were
also supported by the American Bankers Association and America's Community Bankers. Unfortunately, for reasons related to congressional budget scoring, these amendments will not become effective until October 2011. Nevertheless, when the Federal Reserve is able to begin paying interest on required reserve balances, much of the regulatory incentive for depositories to engage in resource-wasting efforts to minimize reserve balances will be eliminated, to the economic benefit of banks, their depositors, and their borrowers.

The act will also allow the Federal Reserve to pay interest on contractual clearing balances and excess reserve balances, two types of balances that depository institutions hold voluntarily at Reserve Banks. By helping to stabilize the demand for voluntary reserve balances, this authority may allow the Federal Reserve to implement monetary policy without the need for required reserve balances. In these circumstances, the Board - as authorized by the act - could consider reducing or even eliminating reserve requirements, thereby reducing a regulatory burden for all depository institutions.

Other important provisions of the act will provide banking organizations immediate regulatory relief. For example, the act immediately raises to $500 million, from $250 million, the asset threshold below which a well-capitalized and well-managed insured depository institution may qualify for an extended eighteen-month cycle for safety and soundness examinations. We estimate that this change will allow about 1,200 additional federally-insured institutions to qualify for an extended examination cycle without compromising safety and soundness.

The act also requires that the Board and the Securities and Exchange Commission (SEC) jointly issue a new, single set of rules to implement the "broker" exceptions for banks that were adopted as part of the Gramm-Leach-Bliley Act. The act requires that our agencies jointly issue new proposed rules within 180 days of enactment, but Chairman Cox of the SEC has actively engaged with the banking regulators on this issue and has already indicated that he would like to have proposed rules ready for public comment by the end of this year. We look forward to continuing to work with Chairman Cox, the SEC's other commissioners and staff, and our fellow federal banking agencies in developing workable rules that do not disrupt the traditional activities of banks.

**Conclusion**

I have covered a lot of ground today. My central theme has been that good regulatory and supervisory policies should implement congressional intent in ways that maximize social benefits and minimize social costs. The regulatory burden on banks is not the only element of social cost, but it is an important component. Accordingly, in developing regulatory and supervisory policies, the Federal Reserve and the other banking agencies will continue to pay close attention to the implications of those policies for regulatory burden, competitiveness, and efficiency in banking. In practice, our ability to accurately assess those costs and benefits depends greatly on close collaboration with and feedback from the banking industry. We look forward to working with you on these issues.

**Reference**