

Diverse Views on Revamping Regulation

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(First of three parts.)

As lawmakers were calling for an overhaul of the federal banking agencies this past fall to follow a massive intervention to prop up the industry, most executives agreed with them.

Congress has held off from reforms this year — choosing to focus on the unprecedented bailout — but over 73% of roughly 150 executives asked about reform in an *American Banker* survey said they support it.

That is where the agreement ends.

The Executive Forum survey, conducted in October with Greenwich Associates LLC, found bankers divided into two camps based largely on size. Large-bank executives were more uniform in calling for an overhaul and said the current level of oversight is too weak. Small-bank executives said any reform should be focused on making oversight more efficient and reducing unneeded burdens.

Observers said large institutions recognize that the current turmoil stems in part from outdated regulations' inability to catch up to changes in the business.

"Because of what's happened in the current environment, and because we've seen where the loopholes are," regulatory reform "just makes sense," said Melissa Netram, the director of regulatory affairs at the Financial Services Roundtable. "There are so many products and services that were not thought about in the legal and regulatory structure that was developed in the '30s."

But small-bank executives feel just as strongly that the current structure leaves them overregulated, with overlapping agencies and repetitive compliance requirements eating up resources.

"The compliance burden on a smaller bank — in terms of needing the people and the systems in place — is killing them," said Nicholas Ketcha, a former director of the Federal Deposit Insurance Corp.'s division of supervision and now a managing director at

the bank consulting firm FinPro Inc. "With the larger banks, they can afford to have a separate department" to focus on compliance. "It's inconceivable for the smaller banks to do that."

Bankers expressed their support for reform at a time when things were already changing in the industry at lightning speed, entirely because of crisis management. In the month before the survey was conducted, Lehman Brothers, Merrill Lynch & Co. Inc., and Washington Mutual Inc. had collapsed or been consolidated. Others, such as Goldman Sachs Group Inc. and Morgan Stanley, shed their traditional structures to seek direct regulation from the Federal Reserve Board.

In early October, Congress debated and passed the \$700 billion bailout. Regulators then quickly launched programs to invest half of that amount directly into institutions and backstop senior debt issuances.

Though Congress gave the unprecedented aid its blessing — viewing it as necessary to stabilize the financial system — lawmakers repeatedly made the case that reform was needed once the dust settled.

Ernest Patrikis, a former general counsel at the Federal Reserve Bank of New York, said institutions and regulators have already been upended by the turmoil.

"We've had a massive change in our financial structure with the Fed becoming the umbrella supervisor of a number of larger organizations," said Mr. Patrikis, now a partner at White & Case LLP. The Office of Thrift Supervision "has lost through acquisitions and failures its major supervised firms," and the Securities and Exchange Commission's "track record has been blemished by what's happened across the board in the broker-dealer industry."

But policymakers need to slow the process down and make sustainable reforms, he said. "Now is the time to really take a step back and look at the structure and say, 'What is an optimal structure?'"

Bankers, particularly those at large institutions, are not arguing with that. In the survey, 92% of executives at 24 institutions with over \$10 billion of assets said reforms were needed, and 56% of the executives said the degree of regulation was insufficient.

Respondents who saw the need for stronger oversight — 17% of the 151 bankers asked that question — said the regulatory structure failed to recognize the risks that led to the credit debacle.

"I believe the lack of sufficient regulation and oversight has caused much of the market collapse and industry consolidation challenging the U.S. financial services sector today," one respondent said. "The lack of regulation has allowed banks to increase their portfolio with an excess of highly risky assets, seeking the potential large return."

"The collapse of these risky positions are causing banks to fail."

On the other side of coin, executives who say there is too much regulation — a group more likely to represent community bankers than others — said that better regulation does not mean bigger regulation, and that regulatory ineffectiveness resulting from poor focus stoked the crisis.

"The regulators are looking too deeply into how we perform our services at a micro level, and less at the larger picture of why they're regulating," one banker said. "The regulatory focus needs to be reset."

Others cited a need to consolidate agencies and to base assignments on business functions, rather than an institution's charter class. Many reform proposals, including the Treasury Department's March blueprint, have called for the absorption of certain agencies into others, as well as more principle-based oversight.

"A myriad of state and federal laws that often conflict, as well as differ from state to state, makes compliance extremely difficult and subjects the lender to significant potential liability," one banker said.

Just under 60% of executives at institutions with less than \$10 billion said their level of regulation was too high, compared with only 30% of those at larger institutions.

When asked what type of reform they supported to improve the structure, the most popular option among executives overall was consolidating agencies (48%), followed by a realignment of oversight "by function" (27%).

"New legislation should require additional regulation," one respondent said. "However, for small community banks, the regulations we have to work through sometimes require more time and effort than what they are intended to protect. Many regulations are in place because someone in the past neglected to follow common sense, so the rest of us have to pay for it."

Another banker said the agencies need to become better at interpreting information, rather than simply requesting data, which imposes a burden on the compliance staff.

"The reporting and paperwork requirements of many regulations are expensive relative to the public benefit or value," the respondent said. "Regulators are often at their best sifting through the garbage to determine what was on the menu after the banquet is over, but they seldom understand the recipes used either before or after the meal."