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Introduction to Financial Services: "Regulatory Relief"

The 114th Congress is considering legislation to provide "regulatory relief" in the area of financial services. This *In Focus* gives a broad overview of the policy tradeoffs inherent in relief and the forms that relief proposals could take. It does not cover specific proposals, but instead provides a framework for evaluating any proposal, whether it is targeted at banking, securities, derivatives, or insurance. CRS takes no position on specific regulatory relief proposals or the relative balance between costs and benefits achieved in the current regulatory structure.

Policy Tradeoffs

In determining whether to provide regulatory relief, a central question is whether an appropriate tradeoff has been struck between the benefits and costs of regulation. In other words, can relief be provided while still maintaining the stability of the financial system and ensuring consumers are protected, or would relief undermine those goals? Regulatory relief is generally focused on the providers of financial services—such as banks, broker-dealers, and other institutions—but what effect would relief have on consumers, investors, particular markets, and market stability more broadly? Understanding the benefits and costs of regulation is a precondition for deciding whether the appropriate balance has been achieved.

Benefits. Financial regulation has different objectives and potential benefits, including enhancing the safety and soundness of certain institutions; protecting consumers and investors from fraud, manipulation, and discrimination; and promoting financial stability while reducing systemic risk.

Regulators employ different tools to achieve these goals. Regulators issue rules; supervise and examine institutions to verify that the rules are followed; and take certain enforcement actions, such as imposing fines, when the regulations are not followed. In other cases, regulators require companies or individuals to meet certain standards and receive a license before engaging in a particular business practice.

The specific goals regulators attempt to achieve and the tools they used vary by market. For example, risk management is emphasized for banking regulation and disclosure is a priority in securities regulation.

Costs. The costs associated with government regulation—rulemaking, supervision, and enforcement—are referred to as *regulatory burden*. The presence of regulatory burden does not necessarily mean that a regulation is undesirable or should be repealed. A regulation can have benefits that could outweigh its costs, but the presence of costs means, tautologically, that there is regulatory burden.

The concept of regulatory burden can be contrasted with the phrase *unduly burdensome*. Whereas regulatory burden is about the costs associated with a regulation, unduly burdensome refers to the balance between benefits and costs. For example, some would consider a regulation to be unduly burdensome if costs are in excess of benefits or the same benefits could be achieved at a lower cost. But the mere presence of regulatory burden does not mean that a regulation is unduly burdensome.

Regulatory requirements are often imposed on providers of financial services, so financial institutions are often the focus of discussions about regulatory burden. But costs associated with regulation can flow through the providers and be ultimately borne, in part, by different entities, including financial institutions, consumers, the government, and the economy at large. For example, a provider may respond to increased regulatory burden by raising the prices it charges to customers.

Regulatory burden may manifest itself in different forms. *Operating costs* are the costs the company must bear in order to adhere to the regulation, such as employee training. Some operating costs are one-time costs borne upfront while others are recurring costs that exist so long as the requirement is in effect. *Opportunity costs* are the costs associated with foregone business opportunities because of additional regulation. A lender may, for example, make fewer mortgages because new regulations make mortgage lending more expensive and instead perform a different type of lending that is now more profitable.

> 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. – Federal Reserve Chairman Ben Bernanke, 2006

Tradeoffs. Regulatory relief may face tradeoffs between reducing regulatory burden and potentially reducing the benefits of regulation (e.g., safety and soundness, consumer and investor protection, and financial stability). Policymakers consider these tradeoffs and evaluate the broader effect that regulation will have in certain areas that could be either positive or negative, such as how a requirement would impact innovation, the price of credit, and the availability of credit. For example, efforts to protect consumers against actions taken by banks may drive up the cost for a bank to provide certain services, such as smalldollar loans for $100 or $200, and result in that activity migrating to a less regulated part of the financial system, such as payday lenders, or to foreign jurisdictions with lower regulatory standards.

However, tradeoffs are not always present. If regulation makes an unstable system more stable, it could reduce cost and increase the availability of credit.

Statutory Requirements to Consider Regulatory Burden

As part of the rulemaking process, Congress has required regulators to consider ways to minimize regulatory burden. For example, the Paperwork Reduction Act (44 U.S.C. §§3501-3521) requires regulators to report the hours that institutions will spend complying with their requests for information. This "paperwork burden," is just one component of regulatory burden, however.

Pursuant to the Regulatory Flexibility Act (5 U.S.C. §§601-612), financial regulators are required to include in rulemakings an assessment of the rule's impact on "small entities," which includes—but is not limited to—small financial institutions. Agencies are only required to make an assessment about possible alternatives and projected costs of the rule, however, if they believe that the rule will have a "significant economic impact on a substantial number of small entities."

Each financial regulator has different statutory requirements for performing *cost-benefit analyses*, but broadly speaking, they have a varied set of requirements for considering costs and benefits of their regulations and are not subject to the same requirements as executive agencies. Because quantitative analyses are not required for all rules, it is not possible to sum up the expected costs of all regulations and quantify the overall magnitude of regulatory burden.

Cost-benefit analyses can be quite difficult to perform for financial regulations. The costs may be more concentrated or tangible and therefore easier to quantify, whereas the benefits may be more diffused and not materialize for an extended period of time. For example, how does one quantify that a regulation decreases the likelihood of a financial crisis? Despite the challenges of quantifying financial rules, some believe a more rigorous analysis would help minimize regulatory burden and encourage more cost-effective regulations.

Forms of Regulatory Relief

Some regulatory relief policies can be characterized as *forward-looking*—focusing on how to reduce the burden associated with future rulemakings, such as strengthening existing cost-benefit analysis requirements on financial regulators to bring them in to line with executive agency standards. Alternatively, regulatory relief can be *backward-looking*—modifying existing regulations. Modifications can be made to regulations stemming from statutory requirements, regulatory or judicial interpretation of statute, or those originating from regulators' broad discretionary powers.

As relief proposals are debated, a useful framework to categorize proposals includes assessing through what *channel* relief would be provided, to *whom* relief would be provided, and *how* relief would be provided.

If policymakers choose to provide regulatory relief, they could do so through several different channels. Legislation could be enacted that would affect a regulation in a specific way. In other instances, regulators already have authority to adjust regulations on their own without additional authority from Congress. Regulators could make changes individually, regulation-by-regulation, or they could reassess regulations in a more comprehensive manner. For example, under the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA; 12 U.S.C. §3311), the banking regulators review regulations every 10 years to identify regulations that are "outdated, unnecessary, or unduly burdensome" (a review is currently being conducted). Some regulations have also been successfully challenged in court, although this form of relief may only be temporary because regulations might then be reissued in a modified form.

In addition, policymakers must determine to whom—if anyone—relief should be provided. Relief could be provided to either all firms to which a regulation applies or only a subset of firms based on firm size, firm type, or the activities a firm performs.

Policymakers would also need to consider how relief should be provided, for example, by repealing entire provisions, providing exemptions from specific requirements, or tailoring a requirement so that it still applies to certain entities but in a less burdensome way. Examples of different forms of tailoring are streamlining the regulation, grandfathering existing firms or types of instruments from the regulation, or phasing in a new regulation over time.

CRS Resources

CRS Report R43087, *Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets*, by Edward V. Murphy.

CRS Report R41974, *Cost-Benefit and Other Analysis Requirements in the Rulemaking Process*, coordinated by Maeve P. Carey.

Sean M. Hoskins, shoskins@crs.loc.gov, 7-8958
Marc Labonte, mlabonte@crs.loc.gov, 7-0640

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