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SOME REFLECTIONS ON OUR DUAL BANKING SYSTEM

By William M. Isaac*

This morning I would like to talk about our dual banking system -- the role it has played in the development of America's banking system and the challenges it faces as our financial system continues to evolve.

At the outset, I am reminded of some words of caution written by Charls Walker, then Executive Vice President of the American Bankers Association:

> For all its uniqueness, the dual banking system is not well understood by legislators, principals, and staffs of the regulatory agencies or the general public. To all too many it is thought of as a device to whipsaw public regulatory bodies for narrow, selfish interests or, equally bad, as another example of accidental confusion in government with which the present generation must unfortunately live and make function. Even bankers are sometimes prone to see the system as a bothersome substitute for more rational regulation rather than an integrated system of value in its own right. All too often the phrase "dual banking" is used as a shibboleth for industry self-interest.

Yet for all the misunderstanding and inappropriate defenses, the dual banking system has indeed been one of the cornerstones of our financial system. A careful and thoughtful evaluation of this unique system is required; we must recognize the pressures that are bearing down on it. What responses could or should we, as supervisors, bankers or elected officials, be considering? What is the continuing role of a dual banking system in our changing environment? These are the key questions before us -- they will be answered by our actions or inaction in the coming years (not by my speech this morning!).

A Brief Chronology

It is useful in considering the dual banking system to recall some of the powerful socio-economic forces which shaped our emerging nation and molded our current financial system -- the Revolutionary War and Civil War financing demands, the industrial revolution, and the intermittent financial crises culminating in the Great Depression when

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nearly one-third of our banks failed and millions of people lost their life savings. Perhaps the most important ingredient is the pioneer spirit of our people which manifests itself in a strong and independent will and an equally strong distaste for concentrations of power, particularly in government.

A brief chronology of a few well-known dates not only serves to remind us of the slow evolutionary process toward a dual banking system, but also underscores the historic philosophical crosscurrents -- an aversion to centralized power, on the one hand, and a desire to protect the public from imprudent or abusive banking practices, on the other.

-- Some students of history date the beginning of the dual banking system in 1781 with the chartering of the Bank of North America by the Continental Congress. The primary purpose of this bank was to finance the military operations of the newly-formed federal government. But, because the legality of its federal charter was open to question, the Bank of North America subsequently obtained a charter from the Commonwealth of Pennsylvania just for good measure. This might be stretching a bit the origin and the meaning of our "dual banking system."

-- In 1791, just 10 years later, Congress granted a 20-year charter to the First Bank of the United States, in large part the result of Alexander Hamilton's relentless efforts to establish a national bank. This bank was quite successful, both in fostering economic growth in a young nation and in handling its own finances; nevertheless, its charter was not renewed as a spirit of independence and an aversion to centralized power prevailed.

-- In response to abusive banking practices that sprang up in state banks after 1811, the Second National Bank of the United States was chartered by Congress in 1816; but its charter was allowed to expire in 1836.

-- In 1863, with the pressing financing demands of war, the National Currency Act (and the National Banking Act of the following year) created a system of national banks, a national currency, and the Office of the Comptroller of the Currency. At that time, there were 1,466 state banks in operation. Congress, in its wisdom, imposed a 10 percent tax on state bank notes. Not surprisingly, by 1868 the number of state-chartered banks had shrunk to 247, while nationally-chartered banks had increased to 1,640. Thus, the conflicts and tensions of a dual banking system began in earnest. The 10 percent tax soon became meaningless as deposits were quickly outstripping bank notes as the major source of funds. State-chartered banks regained their ascendency, and by 1892, state banks actually outnumbered national banks, 3,773 to 3,759.

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-- A central banking authority, the Federal Reserve, was added to the financial system in 1913 to help stem recurrent financial crises. An important issue at the time, which is very much alive today, was whether to require state banks to participate in the system.

-- In 1933, Congress created the Federal Deposit Insurance Corporation to help stabilize the banking system and protect depositors against loss of their life savings. Shortly thereafter, the FDIC became the federal supervisory authority of state nonmember banks, and became inextricably involved in the chartering process since, as a practical matter, the granting of insurance became a necessary part of a bank's franchise. Again, however, Congress elected not to require state bank participation by law.

Thus, we started with a system wherein the states had full and exclusive chartering and regulatory authority. Beginning in the mid-19th century, three distinct socio-economic-political eras produced our present tripartite federal regulatory structure -- the Comptroller of the Currency, the Federal Reserve and the Federal Deposit Insurance Corporation -- which continued to evolve in later years as we added new authority and responsibility. It may be unfair to say that our dual banking system evolved by historical accident, but it certainly did not evolve by some grand design.

Characteristics of the Dual Banking System

The first and foremost characteristic of our state/federal system is that it embodies the principle of checks-and-balances on power. The fact that a bank can choose entry either through the state or federal chartering process and that it can change its primary supervisor, creates a check on the regulator's authority and potential for abusive or simply unwise actions. A second attribute of our state/federal system is that with authority remaining at the local level, bank regulation is brought closer to the people and their communities. Laws and regulations -- indeed, the structure of banking -- can be tailored to the particular needs and requirements of our various communities; the system can be more responsive. Finally, a decentralized regulatory structure can provide more opportunity and incentive for experimentation and innovation by banking firms and regulators alike.

At its best, the dual banking system would possess all of these strengths. Yet the reality is that a growing federal presence in the state banking system has tempered freedom of choice. Moreover, some would argue that freedom of choice of charter and supervisor has at times led to laxity in regulation. Finally, it must be recognized that local governments have the potential to be more responsive not only to the broader public interest, but also to more narrow special interests.

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For all its weaknesses, both real and perceived, I believe the dual banking system has served us well and, on balance, offers continuing advantages. I am persuaded of the fundamental strength of the twin pillars on which our dual banking system is founded -- the principles of checks-and-balances and decentralized power. These principles have been important throughout America's history and have found particular relevance in banking. A system fashioned by these two principles has a great deal of flexibility -- the ability to change with the times, to survive.

The Forces of Obsolescence

Many people have recalled Mark Twain's cable from London to the Associated Press: "The reports of my death are greatly exaggerated." I certainly do not want to exaggerate the forces which are converging on our dual banking system. However, these forces are presenting some serious challenges to the dual banking system and are making its future viability at least open to question. The challenge to the system is not a clean-cut or dramatic issue of life or death -- it is simply one of obsolescence, which the dictionary defines as "out-of-date" or "no longer used or practiced."

Everyone recognizes the financial problems that have long plagued state banking commissions. These problems are no doubt exacerbated by the extensive federal presence in state bank supervision. The incentive for states to allocate resources to this activity is certainly reduced when it is recognized that the federal government will provide the service in any event.

Beyond the financial dilemma, several major socio-economic forces are making themselves felt. Virulent inflation is having a tremendous impact on the entire economy. In the regulatory arena one implication is the increased necessity to streamline the regulatory process and eliminate duplication of effort at both the state and the federal levels. Moreover, inflation and the attendant high interest rates have raised the cost of idle Federal Reserve balances to the point where a number of banks have withdrawn from membership. This has created an imbalance that favors the state banking system and, thus, ought to be corrected. However, we must recognize that the resolution of this issue will certainly create pressures in the other direction, which will be greater or lesser depending on the particular form of the resolution.

A second major force of the past two decades has been the increased scope and complexity of our economic and financial system. We are experiencing the "internationalization" of our economy in the broadest sense of the term. Our industrial companies initially went overseas to expand their markets. Our banks followed suit with multinational operations to serve the financial needs of these customers and, in the process, found customers abroad themselves. Foreign companies, including financial institutions, are now turning their attention to the U.S. market. Banks have crossed state boundaries through holding company acquisitions of

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finance, mortgage, factoring, and leasing companies and through Edge Act offices, loan production offices, and credit card operations. In addition, businesses and consumers have become increasingly sophisticated customers of financial services. Banks, even many of our smaller banks, do not simply take deposits and make loans anymore, they are offering a wide array of financial services and are competing more directly with credit unions, thrifts, leasing companies, brokerage houses, and other financial intermediaries. These structural changes are placing substantial pressure on our state/federal system. It is becoming increasingly difficult for an agency that has limited jurisdiction over a piece of the puzzle to fully comprehend and properly regulate the whole. Moreover, as competition intensifies between various foreign and domestic financial institutions, these institutions become less tolerant of inconsistent or unequal treatment and demand a more uniform regulatory framework. This tension on the state/federal system can only intensify as we continue down the road toward a more open competitive environment.

A final source of pressure on our dual banking system is the social revolution of the 1960s which has continued into the 1970s. There is more concern and emphasis regarding consumer and civil rights issues, and there is a distinct tendency to seek answers at the federal level. The federal government has responded with several major pieces of legislation, partly because some states have not taken the initiative, but primarily because it is simpler to enact one federal law than 50 state laws, and it has been felt that all citizens should receive equal treatment under these laws. Social legislation has greatly expanded the role of the federal bank regulatory agencies since we must now ensure compliance in the areas of consumer affairs, civil rights, and community reinvestment.

A Few Ideas for Cooperative Action

As I said at the outset, I personally believe in the concept of a dual banking system; it has served well the needs of a growing and diverse nation. The demands for efficiency, consistency, expertise, and social responsiveness are challenging the dual banking system and could render it obsolete in a future environment. It is incumbent upon us to make every reasonable effort to assure that does not happen by default -- through our own neglect.

It is in the interest of bankers and bank supervisors, and it is in the public interest, that we foster a sound, profitable, competitive, and socially responsive banking system. At the same time, it is essential that we endeavor to make our regulatory system as efficient as possible -- one that involves a minimum of cost, delay, irritation, and frustration. As we turn our attention toward this latter objective, in the context of our dual banking system, there are two major areas where we could bring about impressive results. The first is in the area of examinations; the second is in the area of applications.

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The burden of dual supervisory examinations for state banks can be substantially reduced. The FDIC still conducts nearly 60 percent of its safety and soundness examinations on an independent basis. However, we are experimenting, in cooperation with various state banking departments, with the concepts of joint, concurrent, and alternating examination programs. Although they present some problems, these programs, particularly the alternating (or divided) examination, show considerable promise.

The FDIC has taken other initiatives to allocate its examination resources more efficiently. For example, in sound banks examinations are required only once every 18 months and increased authority has been given for modified or shortened examinations. Thus, we are focusing our attention on those banks that are experiencing, or in our judgment are likely to experience, difficulty.

Some have suggested that the FDIC, as the insurer of the nation's banking system, experiment with a program of accompanying state, and perhaps even national, examiners on examinations in lieu of conducting full-scope exams. Another possibility is legislative reform to permit the FDIC to withdraw from routine examinations and certain regulatory functions in states that have banking departments that meet certification standards established by the FDIC. Certainly we should remain open to these and other suggestions for streamlining the examination process.

The delay, duplication, and expense involved in the current application process for branches, mergers, insurance and the like could also be substantially reduced. We might explore the possibility of standardizing the forms that banks file with both the state authority and the FDIC when applying for insurance, a new branch, or a merger. Banks are currently required to provide essentially the same information to state authorities and the FDIC in a variety of formats. This involves obvious waste and inefficiency for all concerned. In a recent speech before the Conference of State Bank Supervisors, Chairman Sprague stated if standardized forms are developed, the FDIC is prepared to bear the cost of printing the forms and distributing them to state bank supervisors.

A source of real concern to me is the length of time it takes to process applications. There will be occasional logjams caused by an uneven workload, and inevitably some applications will raise difficult issues, the resolution of which will require time. But we should not tolerate delay due purely and simply to inefficient processing procedures. In a number of states today, for example, state banks are discouraged from even filing applications with the FDIC until after the state has acted. This precludes simultaneous processing of applications by the two agencies and unnecessarily protracts the proceedings. While the FDIC seldom announces a decision on an application before the state authority has acted, in most cases it can and should be ready to act very soon after the state authority has granted approval.

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The FDIC has taken the initiative to reduce application processing time by delegating authority to our Regional Offices for approval of branch applications that meet certain minimum requirements. Ninety percent of all branch applications were approved under delegated authority by our Regional Offices last year. We are considering ways of delegating additional authority in other areas.

The Greater Challenge

As we actively pursue all available avenues to make the dual regulation of state banks less burdensome and more efficient, we should also turn our thoughts toward the larger questions raised by the structural changes occurring in the financial services industry. Today we are experiencing the formation of a financial services industry which crosses state and national boundaries and which blurs the previous market distinctions between banks, thrifts, credit unions, brokerage firms, and investment houses. Structural changes of this magnitude -- those which have already occurred and those we are likely to witness over the next decade -- require us to re-examine some of the fundamental assumptions underlying our financial services industry. How should we balance the desire for uniform and consistent treatment of individuals and institutions and the desire to preserve the system of checks-and-balances and decentralized power that is the basis of our dual banking system? This is a vital and challenging question which has important implications for the entire banking industry and even the public-at-large. It ought not to be resolved by default.

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