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THE CHALLENGE TO THE DUAL BANKING SYSTEM

An address by

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to the

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THE CHALLENGE TO THE DUAL BANKING SYSTEM

By William M. Isaac

Today I want to talk about one of the cornerstones of our financial system: the dual banking system. It is a system comprised of state and national banks and state and federal banking authorities that has served our nation well for more than a century. It is also a system that has experienced a fair amount of pressure for change in recent years. Indeed, some critics have suggested that it be done away with, and a new, more centralized system for the chartering and regulation of banks be substituted.

A new threat to the dual banking system has been recently added. I speak, of course, of the Depository Institutions Deregulation and Monetary Control Act of 1980 which was signed into law on March 31. The provisions of this Act altered the powers and responsibilities of various federally-regulated depository institutions and provided for the phase-out of deposit interest rate ceilings. These changes portend an intensified competitive environment in the financial services industry.

The most significant implications for the dual banking system, however, flow from the establishment in the new law of mandatory reserve requirements and broader access to the Federal Reserve's services and discount window. The new reserve requirements will be phased in over an eight-year period for existing state nonmember banks. At the end of that phase-in period, a very important advantage of state

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nonmember banks -- the absence of any requirement for the maintenance of sterile reserves at the Federal Reserve -- will have been eliminated. At that point, if not sooner, bankers are bound to take a more critical look at the system of dual regulation under which state banks operate and ask whether a single-regulator system would be less burdensome.

I believe that this will result, ultimately, in greater incentive for conversion of banks from state to national charters, unless the states and the FDIC join forces in an effort to reduce the inefficiencies in our present system of dual regulation. This is the subject I want to discuss today -- but let me set the stage with a little history on the development of our dual banking system, a discussion of its attributes, and a review of the pressures for change in the system.

Background

The first commercial bank was chartered by the Continental Congress in 1781, 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. Other states soon followed Pennsylvania's lead so that our early banking system was comprised entirely of state-chartered banks.

Ten years after the founding of the Bank of North America, Congress granted a 20-year charter to the First Bank of the United States. The Bank was quite successful, but it was viewed as a monopoly and was considered far less

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efficient than state banks, so its charter was allowed to expire in 1811. Its demise reflected a strong distaste for concentrations of power -- particularly in the federal government -- a distaste which has continued as an important part of our heritage.

Between 1811 and 1815, the number of state banks rose from 88 to 208, and since the Treasury no longer had a national bank to act as its fiscal agent, it kept its deposits in 94 different banks. Without the stabilizing influence on the money supply formerly rendered by the Bank of the United States, prices doubled by 1815. These inefficiencies and economic circumstances led to the creation of the Second Bank of the United States, which was chartered by the Congress in 1816.

The Second Bank was also granted a 20-year charter, and it eventually operated 25 branches in 19 states. The restrictions it placed on the issuance of state bank notes and its exemption from state taxes rekindled fears of an increasingly strong concentration of economic power in the federal government. Thus, the bank's charter was permitted to expire, ending the federal presence in banking for more than 30 years.

In the ensuing years, the number of state-chartered banks rose rapidly. By the early 1860s, the pressing financing demands of the Civil War required a reorganization of our financial structure. At the time, there were nearly

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1500 state banks, each issuing its own bank notes. In 1862, Congress permitted the federal government to issue paper currency and to declare it legal tender, for the first time since the American Revolution. The National Currency Act of 1863 and the National Bank Act of 1864 created a system of national banks, a national currency, and the Office of the Comptroller of the Currency. To encourage a uniform currency system, Congress imposed a tax on state bank notes which eventually was increased to 10% in 1865. At the beginning of 1865, there were only 450 national banks, of which 150 were rechartered state banks. By July 1865, there were more than 1,600 national banks and only 300 state-chartered institutions. The conflicts and tensions of a dual banking system had begun in earnest.

The stiff tax on state bank notes nearly destroyed the state banking system, but the emergence of the demand deposit account as a principal component of the nation's money stock led to the system's resurgence. Other circumstances also promoted the growth in the number of state banks. State banks were able to offer mortgage loans, which were forbidden to national banks, and were generally subject to much smaller statutory initial capital requirements. By 1900, there were 3,790 national banks and 5,000 state-chartered banks, and state banks held 55% of total deposits.

To reduce the instability associated with a series of financial crises in the late 1800s and early 1900s, a central banking authority, the Federal Reserve, was added to

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the financial system in 1913. The Federal Reserve Act also expanded the powers of national banks by granting authority for real estate lending and trust powers.

In the 1920s and early 1930s, the country experienced an unprecedented wave of bank failures. One of the outcomes of our nation's greatest financial crisis was the creation by Congress of the Federal Deposit Insurance Corporation in 1933. The deposit insurance system was intended to serve two purposes. First, it was needed to restore public confidence in the banking system, which had been rapidly eroding as many depositors suffered losses of their life savings. Secondly, deposit insurance served to moderate the abrupt contractions of the money supply that resulted from bank failures -- either by reducing significantly the number of bank failures, or, in their event, by providing a method for expeditiously releasing deposits tied up in suspended banks. Congress did not mandate state bank participation in the federal insurance program, although state-chartered banks were permitted to join. The FDIC has become today the federal supervisory authority for most state nonmember banks, since as a practical matter, deposit insurance has become a necessary part of a bank's franchise.

Thus, we started with a banking system in which the states had full and exclusive chartering and supervisory authority. Beginning in the mid-19th century, a series of economic and political events produced successively the elements in our current tripartite structure of federal bank

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regulation: the Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit Insurance Corporation. These three federal agencies, as you are all aware, have continued to evolve as they have been given additional authority and responsibility.

Clearly, if one were given the task of designing a federal structure of bank regulation today, the likelihood of a tripartite structure emerging would be very small. I think it fair to say that some of the criticisms of the state/federal system of banking supervision are in reality complaints about overlapping federal jurisdictions.

Attributes of the Dual Banking System

We need to be cognizant of both the strengths and weaknesses of the dual banking system. Our efforts should be directed toward preserving and even enhancing the system's strengths while shoring up its deficiencies. It might be useful, in view of the criticism that has been leveled at the dual banking system in recent years, to take a quick look at some of the system's attributes.

Chartering and supervision of banks by state authorities has the great advantage of local-level jurisdiction, which can offer greater understanding of, and responsiveness to, our citizens and their communities. Laws and regulations -- indeed, the structure of the banking industry -- can be tailored to the particular needs and requirements of various localities.

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Another important strength of our dual banking system is that it embodies a system of checks and balances between two levels of government and helps to ensure the decentralization of decision-making power. It serves as a safety valve against concentration of power in the hands of a few decision-makers, who can become imperceptive or complacent, and against the potential for abusive or simply unwise actions. We should cherish this source of countervailing power, for it is the remaining defense against the awesome federal insistence on uniformity, which may not always be optimal for our banking system or our nation.

Decentralization of authority among the states also provides 50 laboratories in which to observe developments, study problems, and experiment with solutions. It is usually less expensive and disruptive to conduct such experimentation at the state level, and we can have the advantage of several different attempts to solve a common problem conducted simultaneously in several states, usually with speedier implementation than federal efforts could provide.

I cannot overemphasize the benefits of this feature of the dual banking system. The history of banking in this country reveals ebbs and flows in the attractiveness and dominance of the state-chartered and nationally-chartered banking systems, as the respective legislative and regulatory bodies were more or less responsive to changing conditions in the industry. Through the years, individual

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states have often led with many improvements later adopted by other states and by the federal system. For example, bank deposits were insured by state-sponsored plans nearly a century before there was any federal program. State banks led in the establishment of branches and, in fact, the McFadden Act was designed to liberalize the branching restrictions imposed on national banks so they could better compete with state banks. State banks had real estate lending powers and trust powers long before national banks. The precedent for lower reserves against savings accounts than against demand deposits can be found in state law. Some states required prior approval for changes in bank ownership before this provision was incorporated into federal statutes. State systems pioneered the process of conducting examinations from the top down, a practice which is widely used by federal bank regulators today. This kind of leadership demonstrates the vitality and innovative spirit that has been a principal benefit of the dual banking system.

Pressures for Change

Despite the record of good service our nation has received from the dual banking system, we must be cognizant of changes that are occurring in our financial and economic systems, and in the world at large, which present serious challenges to the continued operation of our dual banking system in its current form. I certainly do not want to

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exaggerate the forces which are converging on our state/federal system of regulation, but we should recognize that they are important enough to make the system's future viability at least open to question.

To begin with, over the past two decades, there has been an increase in the scope and complexity of our economic and financial systems. 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, have turned their attention to the U.S. market. In short, the world is characterized by a greater level of integration and interdependence.

On the domestic front, banks are finding themselves competing more directly and intensely with other types of depository and nondepository financial intermediaries. State boundaries have been eroded through devices such as Edge Act Corporations, loan production offices, and holding company nonbank affiliates.

As competition intensifies among various foreign and domestic financial institutions, these institutions become less tolerant of inconsistent or unequal treatment and demand a more uniform regulatory framework. Moreover, it is

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increasingly difficult for any governmental authority, state or federal, that has limited jurisdiction over a piece of the puzzle to fully comprehend and contribute to proper regulation of the whole.

Another source of pressure on our state/federal system is the social movement of the 1960s and 1970s, which will likely continue in the years to come. There has been a greater concern and emphasis on consumer and civil rights issues, and there is a distinct tendency to seek answers at the federal level which apply to all depository institutions, regardless of charter. Congress 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 that all banks -- both federally- and state-chartered -- comply in the areas of consumer affairs, civil rights, and community reinvestment.

The expansion of the role of government that has accompanied these changes has also heightened the awareness of our society to the cost and intrusiveness of government. There is less tolerance of needless overlapping jurisdiction, in all functions of government, and a greater insistence on reducing the expense and burden of government wherever possible.

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The principal weakness of the dual banking system, as we know it today, is the great tendency toward redundancy in regulatory and supervisory efforts at the state and federal levels. To the extent this occurs, resources are wasted and, more importantly, state-chartered banks are seriously burdened by duplicative regulatory and supervisory processes. This is a serious criticism of the performance of the dual banking system, for the burden tends to fall disproportionately on the smaller, state-chartered banks.

A Program for Action

It is clear to me that the dual banking system has served us well. The state system has overcome previous challenges to its survival, and has continued over time as a source of innovation and as a manifestation of our nation's distaste for concentration of power.

I believe the dual banking system has the clear potential to serve the country well in the decades to come. Our challenge in the years ahead will be to utilize the great strengths of our federal agencies, such as the FDIC and the Federal Reserve, while retaining the benefits that flow from 50, relatively autonomous, state banking authorities. Among other things, we must dedicate ourselves to reducing the burden of dual regulation of state banks.

There are at least five areas in which we can obtain quick results, and I would suggest we concentrate our initial efforts in these areas.

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1. Examinations. Perhaps the most important area that presents opportunities for coordination is the examination function. It is also the area of largest potential cost savings. At present, the FDIC has four different examination programs worked out with state departments -- independent, concurrent, joint, and divided examinations. Independent examinations by the state and FDIC are costly for both banks and regulators. The joint and concurrent examination programs are coordinated so that a single team of both FDIC and state examiners visits the bank, reducing the cost to both bankers and regulators. A comparatively new approach, the divided examination program, offers the greatest potential cost saving. Under this program, banks requiring special supervisory oversight are examined by both the state and the FDIC each year -- all other banks are examined by the state and the FDIC in alternate years. Neither the state nor the FDIC must abdicate its authority or responsibility with the divided examination approach, but staffing requirements for both can be reduced. The divided program provides for exchange of examination reports, and avoids the difficulty of coordinated scheduling that is required by the joint and concurrent programs.

The divided examination program was initiated in Georgia in 1977, and Missouri and New Jersey were added in 1978. Last year, we agreed to commence a divided program in Illinois, North Dakota, Michigan, and Nebraska, more than doubling the number of participating states. We hope that

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agreements for the divided approach can be reached with at least six more states this year. We estimate that utilization of the program in a dozen states will result in combined state/federal savings in examination expense of $13 million per year.

2. Applications Processing. A second area in which cooperation can reduce duplication and delay is the applications process. We have been encouraging all banks to submit applications to us simultaneously with the submission of their applications to the state authority. We have requested our staff to process these applications concurrently with the state authority to avoid any unnecessary delay. You may be sure that we will not approve an application until the state has given its approval, or we will condition our approval on state authorization.

The FDIC is making every effort to expedite the applications process. Applications guidelines that will aid and simplify the filing of complete applications by the banks have been distributed to our Regiional Offices. Moreover, we have delegated authority to our Regional Directors for approval of the great bulk of applications that are filed; nearly 95% of all applications to the FDIC were approved under delegated authority last year.

3. Common Forms. The third suggestion involves the development of common application forms. Common application forms for state and federal banking authorities would simplify and speed the applications process for state-chartered banks. The FDIC is eager to meet and work with

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the states to develop common forms. Perhaps fully identical forms would not be appropriate, and thus a common "core" application form might be developed, with supplemental parts required separately by the various supervisors.

At this meeting last year, Chairman Sprague said the FDIC believes so strongly in this program that it is willing to bear the full cost of supplying common application forms. While we have had some discussions with the CSBS about this program during the past year, little progress has been made. We hope the project will be completed during the coming year.

4. Training. A fourth area in which there has been proven economies from state/federal cooperation is training. In the past, the FDIC has worked with the CSBS to provide training opportunities for state examiners. Shared state/federal training is a less costly and more efficient approach than separate programs. As you may be aware, the Financial Institutions Reform Act mandates coordinated training of federal bank supervisory personnel through the Examination Council. It is hoped that the states will continue to be full participants in the new, combined program.

5. Shared Data Collection and Analysis. A fifth area in which duplication can be reduced is collection and analysis of bank data, such as the Report of Condition and the Report of Income. Most states require that their banks submit the FDIC's Call Report to state supervisors, thus reducing the reporting burden.

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We can go further. The FDIC can make available on-line computer terminal access to the Call and other reports, so collection and processing costs can be avoided completely by the states. The only costs incurred would be for the terminal/printer and the telephone line charge from the terminal to our nearest Regional Office. For most states, that cost is estimated at less than $700 per month. Seven states are currently tied into our data base and one of them, New York, no longer requires its banks to submit the Report of Condition to the state if the Call is submitted to the FDIC. This procedure is worth exploring for other states as well, particularly those with a large number of reporting banks.

Our computer data base contains current and historical information on all insured banks. Thus, with access to our data base, it is possible to retrieve information for all insured banks in your state or in the nation -- both national and state-chartered. In addition, we make available programs for financial analysis that permit screening for banks that fail to meet pre-set standards for a series of ratios. This information has been valuable to us in the scheduling of examinations and planning their scope, often resulting in a reduction of the number of days that examiners must remain on the bank premises.

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Conclusion

I have mentioned today five areas in which immediate action can be taken to demonstrate our mutual commitment to reducing the burden of dual regulation on state banks. There are, no doubt, a number of other actions that we can take to improve our performance. Suggestions are always welcome from state supervisors and from bankers around the country.

The Commissioners from the states in which the divided examination program has been in operation, along with their first deputies, have been invited to meet with us next month to strengthen our communications and to reinforce our mutual commitment to the program. We plan to discuss other ways in which the FDIC and these states can cooperate and better coordinate our efforts. We hope to have similar meetings with other state bank supervisors -- in relatively small groups so that there may be full, uninhibited discussions.

By working together, we can correct the weaknesses in our state/federal system and build on its strengths. Time is of the essence, however, for the complete phase-in of reserve requirements for our banks will be completed in only eight years. If state-chartered banks view the state-federal interaction as one of conflict and tension, accompanied by unnecessary costs and delays, they will leave the state system. That would be a shame because it is easily avoidable. We have it within our power to eliminate redundancy, reduce costs, and minimize delays.

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It will not be enough to remind bankers how well they have been served by the dual banking system. We must have a positive response to the question, "What have you done for me lately?" Given the changes in the environment in which banks operate, it is a question bankers have a right to ask. We better have a list of good answers.

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