Spch FDIC LeM [on Dual Banking System]

Address by
George A. LeMaistre, Director
Federal Deposit Insurance Corporation
Before the
Iowa Bankers Association
Des Moines, Iowa
October 24, 1973

Library
APR 8 1974
FEDERAL DEPOSIT INSURANCE CORPORATION

As we gather this morning at one of the first association meetings to follow the ABA Convention in Chicago, it is probably not too much to observe that never before have bankers been in a position of needing to assimilate so much information so rapidly. Perhaps I should amend that statement to say so much "important" information -- and further amend it by adding regulators to the assimilation picture. As one who has recently crossed the aisle from banker to regulator, I am aware of the need on both our parts to share ideas and developments back and forth, and this is my purpose today. I don't believe a regulator gives up any of his objectivity when he thinks in terms of changing pews, but not leaving the church.

Any bankers who read the trade journals and especially those of us who were in Chicago, are aware of the unprecedented cross currents buffeting the industry and its regulators. K. A. Randall has detailed the current status of the Hunt Commission Report and its legislative aftermath. (Of course you are all aware that Mr. Patman's Committee has a proposal along these same lines.) High interest rates, disintermediation, wild cards, the recent Congressional action in relation to Regulation Q, the problems of the S&L's and their reaction to these, EFTS developments, all of these ideas just scratch the surface of the far reaching issues facing us.

Today I would think it timely for us to think together regarding one facet of all this, a facet which cuts across many of the issues I have just mentioned but one which all of us in our various capacities have tended to think about in more general than specific terms.

First, however, I would take the perogative of a professor to sketch the development of a couple of ideas which might help us to focus on the issue I have in mind.

If you were to search for a touchstone word to describe America in 1973, you couldn't do much better than "pluralistic". The same is true as an apt description of our banking system. Its growth and development, predicated on the twin forces of profit and great national needs, is unparalleled. Consider this; in England today there are only five or six major banks and a few small ones. In the U.S. there are over 13,000. If we were to look backward, however, we would find a system that in, say, 1773, 200 years ago,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

contemplated only a few institutions, mostly private individuals, who loaned money at what we would term exorbitant rates. A few land bankers came along, lending money with land as security, but fluctuating land values, the absence of stable chartering authority, and the colonial tendency of Great Britian to take out gold and silver all acted to create chaotic currency and banking systems.

In 1781, the first commercial bank was formed in Philadelphia primarily as a means of financing the Revolutionary government. But the general rule was still private and unregulated institutions serving a tiny community usually with some kind of disaster in the making.

In 1791, the First Bank of the United States was chartered with a then amazing capital of $10 million. Alexander Hamilton was, of course, primarily responsible for this development and the bank in turn served as the principal handmaiden of Hamilton's development plans for the new nation. In addition, however, the First Bank impacted drastically on the rest of the industry because its policy was to redeem the notes of the "state" banks. In fact, the Bank's management had the curious notion that the little banks ought to be able to pay up in hard money for their bank notes when presented, and I imagine some of you know the story of Friday afternoon presentations to the small banks -- when the presenting bank would collect bank notes until they felt sure the issuing bank couldn't redeem them in so large a block, present them for redemption at the end of the week when hard money supplies were low and, in effect, close the bank.

As a natural consequence of American ideas of independence (not to mention gentle persuasion of the Congress), the First Bank's charter was not extended when it expired in 1811, and for the next five years, state banks had a field day printing bank notes almost as fast as the presses would run. Since there was no fear of the "Feds" showing up to present the notes for redemption, and since the borrowings of the government to finance the War of 1812 escalated the demand for notes, everybody who could, went into the banking business. The number of state banks increased from 88 in 1811 to 246 in 1816, or almost 300 percent!

The abuses of the colonial period began to appear again and in 1816, the Second Bank of the United States was chartered as a check on ruinous banking practices. You will remember that Nicholas Biddle was not known for his courtesies toward state banks or for his lovable temperament in general. Indeed, Biddle perfected the presentation for redemption idea, often to the point of driving a bank whose practices he opposed out of business.

When Andrew Jackson was re-elected in 1832 he had run on and then followed a policy of opposition to Biddle and to the Bank, and when its charter expired in 1836, Jackson vetoed a bill to recharter it, and the state banks once again reigned supreme.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The great issues involved in this chronology were part economic and part political. Not until Appomattox were the underlying basic political issues put to rest, and as we shall see in a minute it would be fair to say that "banking" political questions and many of the economic issues are unresolved today. The years between the end of Nick Biddle's bank and the rise of a national banking system -- 1836-1863, saw the development of several significant efforts to bring state banking systems under some form of regulatory control, beginning in 1838 in New York, but the system was still a hodge-podge in part because of the historical disagreements about how banking ought to be structured and in part because of the burgeoning economy of a young and incredibly rich land, which created strenuous demands for credit.

Thus, in most states, banks grew almost in an inverse relationship to the trees which were felled to fuel the commercial development of the country. Bank notes were issued by the millions and devious schemes to block presentation grew up, approaching an art form, almost, in the "wildcat" banks idea where management located its main office so far in the woods that only wildcats would live there. Hopefully, note holders would avoid the wildcats and thereby fail to present the notes.

Counterfeiting, bank failures by the gross, and generally shady dealing led to yet another public cry for reform but it was not until the Union government had all but exhausted its credit in 1863 that Congress finally acred, passing the National Currency Act, and the National Banking Act a year later. Incidentally, the National Banking Act passed the Senate by a margin of two votes and then only after strong appeals that the Act was necessary to finance the Federal Army in the war between the states. This Act created a system of national banks, a national currency with reserve requirements, and the Office of the Comptroller of the Currency. It also created in essentially the same form as we know it today, the Dual Banking System.

At the outset, state banks were reluctant to join the national system because it was more profitable to operate on the state side. This changed when Congress in its wisdom, levied a 10% tax on state bank notes and for some reason, this tended to persuade the state bankers to convert to a federal charter in rather astonishing numbers: By 1870, 1,612 national banks were operating as compared to only 325 state banks. These developments had occurred in a span of about 80 years and with a few major modifications to come in the future, such as the creation of the Federal Reserve in 1913 and the FDIC in 1933, the dual banking system was off and running. With the advent of expanded checking late in the 19th century, the 10% tax became ineffective and the State banks began to operate profitably again. By 1900 they outnumbered national banks as they do today. In Iowa, for example, approximately 77% of your banks are state non-member banks.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Now these observations are designed merely to bring us together, as they once said in Washington, so that we can look at an issue at this point in time, as they now say in Washington. Clearly several major forces were at work in the creation of what we all have come to accept as the normal way of doing business through the dual system: the growing economy, the absence of regulation, the fierce sense of independence which is part of the industry and the country, the War of 1812, the Civil War, and the abuses of unfettered banking.

Some of these themes are still with us in more or less degree, but now there has evolved a profound development of consumer consciousness and -- as we all know -- significant other financial institutions who desire more competitive equality.

Which brings us to the dual banking system, and its place in the ongoing development of the banking industry. At the outset I want to -- if you'll pardon the Potomac language -- make it perfectly clear that I am not presenting a brief today on behalf of a unified system or on behalf of the dual system. I am rather trying to present one regulator's personal view on how the dual system question fits into the broader complex of issues which I mentioned a few minutes ago. You all are aware that various proposals are floating around which would have substantial impact on the dual system: mandatory membership in the Fed, or, alternatively, mandatory reserve requirements, truth-in-savings, uniform tax treatment, a unified national system, or the creation of a new office in Washington of the Administrator of State Banks, to mention a few. Now we are all also aware that when a regulator mentions "dual system", bankers get a little nervous and may decide not to invite the regulator back.

And I want to come back. Therefore, I am a little wary of approaching this subject without stating once again rather emphatically that this is not a brief for it or against it -- it is a discussion of it!

The reason this is important is that we are often confronted in Washington with the question, "What <u>are</u> the advantages of the system? But for historical accident, wouldn't we have a unified system as there is in Europe?"

Now we need to start studying ways to answer this question. Although it may suit you and it may suit me, the answer "Because we like it" won't do. We need to get an analytical handle on this question which will withstand close scrutiny, for it will come as no surprise that close scrutiny will be forthcoming.

So, for the remainder of my time this morning, I would like to suggest that we think together about the dual system in somewhat precise form, about the arguments pro and con, and perhaps a little way down the road of where the arguments may lead.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

At the outset it is probably necessary to come up with a workable definition of "dual system" and this could consume the rest of the day. Technically, the idea of a dual system ought to encompass two separate chartering authorities who, after chartering, would examine and regulate, separate and apart from each other. Since our system grew as the product of historical forces, that, of course, is not the case. We have few neat and tidy ideas to work with.

Between 1863 and 1913, there was "pure" duality of a sort, but the advent in 1913 of the Federal Reserve and in 1933 of the FDIC created an overlay of regulation on top of state chartering authority.

For our purposes, then, it would seem we should define the dual system as "things as they are", both on the chartering side, and on the regulatory side. With that in mind, what are the arguments to retain it?

It would seem reasonable that we could group the arguments under three broad headings: the public interest argument, the access argument, and the regulatory argument.

None of these arguments is a whole unto itself -- each overlaps to some extent with the others. But as an analytical tool perhaps they will suffice. The public interest argument runs along the lines of reasoning that both government and economic control is dissipated by the dual system and that this is a desirable result. On the government side, the public is protected from a concentration of regulatory control by one man or a small group of men. This argument assumes a sort of "anti-trust" hue, except it keeps government rather than industry from forming a monopoly. I would observe that this argument seems to have merit; it is generally reasonable to disperse government control in many domestic circumstances.

On the economic side, the system provides for a multiplicity of banks and therefore for a multiplicity of different markets for the public to go to. As a correlative point, it is argued that the existence of this multiplicity of markets provides a given community (which might be defined as broadly as a state) with more choices, thereby cutting down on arbitrary and high handed dealings by, say, one or two large banks. This means that banks are more competitive, but this is a desirable result in our system, as competition polices the market.

The access argument might be termed the classic dual system argument. If a meritorious group cannot gain access to a national charter, it can resort to the state chartering authority and vice-versa. The value of this capability to minimize arbitrary or capricious entry to the market is obvious. It is, some say, the only sure safeguard against a totally concentrated and oligopolistic industry. The other facet of this argument is the existence of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the same capability for existing institutions who have encountered trouble at the regulatory level.

A side effect of this proposition is the check on regulatory authority which the possibility of conversion produces. The argument runs that the regulators are somewhat more restrained because of a wholesale withdrawal of the banks under their jurisdiction is always a possibility, albeit a remote one.

The third argument, the "regulatory argument" has several facets. The first proposition is that the dual system permits more refined shaping of laws and regulations to local and particularized economic needs. A single chartering-regulating authority would, it is said, be incapable of adapting to the needs and problems of banks as different as Chase Manhattan, and a small country bank in Iowa or Alabama. The second facet is the "laboratory" idea: that banking innovations which benefit the public are more likely to come from a widely pluralistic industry than from an industry regulated from Washington. In the mid-60's, for example, it was pointed out in a report to the New York Superintendent of Banks that state banks were primarily responsible for the introduction of branching, loans on real estate, and fiduciary operations. I would observe in this connection that the greater the difference among banks, the greater the probability of meaningful innovation.

There are surely other arguments in favor of the dual system, but for now it seems reasonable to travel with these three broad areas: public interest, access and regulation.

What is the other side?

The arguments against the dual system might be said to fall under two broad headings and, oddly enough, the names of several of these categories have been used in the arguments <u>for</u> the system which I have just outlined.

Consider the public interest argument against the dual system: (1) a multiplicity of small banks without full service denies to the public the benefits of a large bank in their community. Consider further this additional facet: (2) in some states (although surely not in Iowa) political pressure may be brought to bear on the question of who receives a charter. The groups who receive such charters may not be deserving of them and the services of the resulting banks may fall below a reasonable standard.

A third public interest proposition would argue that a lack of uniformity of state banking laws creates a hodge-podge of institutional rules which impart in a harmful way on what is obviously an interstate system. And, some legislatures are, perhaps you could say, a little better organized than others.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Finally, from a public interest viewpoint, it has been argued that the resources of the federal government insure high pay for, and superior training of, examiner, thus tending to insure a better job in the examination.

The "efficiency" argument and the "regulation" argument might best be considered together as the "efficiency in regulation" argument. Its components include the proposition that dual examinations are senseless, a waste of time and money, and a product solely of historical accident. A corollary argument would run that this represents a fragmentation of regulatory responsibility to the end that when everybody's responsible, nobody's responsible.

A second broad theme encompasses the idea that different federal regulatory agencies bicker back and forth, to the detriment of a solid front to the industry. This thesis was most recently articulated at Congressman Patman's hearings, where it was alleged that the agencies couldn't get together on the July 5 changes in interest rates under Regulation Q and their aftermath.

Twin corollaries of this regulatory fragmentation include the proposition that the industry is able to play one agency off against another and that such "shopping" expeditions produce what has been termed "competition in laxity". The final corollary includes the proposition that because of fragmented supervision, different classes of banks are accorded unequal treatment, resulting in inequitable regulation for one or another classes of commercial banks at different times.

Now let me state here and now that I am not contending that this analysis is all encompassing. Rather, it is an effort to focus on several reasonably arguable propositions which deserve scrutiny and discussion by all of us. There is no substitute for informed discussion in approaching this thicket, and I would hope that this outline would provide ammunition for meaningful dialogue in the months ahead.

That such a dialogue will continue and intensify over the next few months is a foregone conclusion. I would offer the hope that "dialogue" is the proper choice of the word, for it is evident that this pot is beginning to boil, and we need to keep firmly in view the necessity for those on all sides of this and related questions to keep talking to each other.

One or two examples of what is bubbling in that pot might be helpful in leaving you with a flavor for what is to come. In late September, the CSBS issued a statement concerning the Fed's wish to approach some 180 non-member banks to request voluntary compliance with the Fed's incremental 60% Reserve requirements on large denomination CD's. The Conference took the position that any membership in the Fed should be voluntary, and that moreover even this experiment did not appear warranted. The statement concluded with this observation:

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

> The health of the dual banking system, therefore, should not be jeopardized in the absence of clear evidence that the centralization of regulatory authority in the Federal Reserve System, through mandatory memberships or reserve-setting authority for all depository institutions, would serve the public interest better than the current regulatory structure.

In early October, at the Chicago ABA meeting, CSBS Executive Vice President Larry Kreider delivered a speech setting out the Conference's position and observing,

> "1973 will undoubtedly be thought of as the year in which the battlelines were firmly drawn for the struggle to determine whether the dual banking system will continue to exist in any meaningful sense."

Similarly, in a speech at your Executive Management Conference which some of you probably attended, Donald Pearson, California Superintendent of Banks and President of CSBS stated that:

> "To many bankers, the precious right to convert is the most important element of our banking system. If the dual banking system were to be lost and all banking were to be placed under one single authority -- as Wright Patman and others have suggested, we should then expect that in due course, such authority would become overly restrictive and there would be no escape. It is for this reason among others, that many national banks and bankers, as well as the ABA and the Hunt Commission Report, give strong support to the dual banking concept."

These remarks have as a common theme, an expressed concern that the dual system is under strong attack and that its proponents ought to circle the wagons. With the President's legislative package now on the Hill, it is likely that even more disucssion will focus on the system and on the proposed modifications, both those which purport to strengthen the system, and those which purport to do it in. I would urge that these discussions be, above all else, positive in tone, and I am happy to cite as an example of one such positive effort the joint FDIC-CSBS experiment in state-only examination which will occur next year in four states. In my judgment this represents a good example of the kind of constructive approach which is helpful, well thought out, and potentially of significant importance in demonstrating renewed vitality in the dual system.

To sum up then, it is possible to trace the way we got here -- from the Revolutionary period to the present...and it is fair to say that the dual system

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

grew like Topsy -- it grew as events and politics shaped it. Therefore, it now reflects an uneasy, untidy but workable accomodation of competing interests, and in broadest form it has the virtue of flexibility. On the other side, its greatest flaw is its inefficiency and waste of money and manpower, and there will surely be a balancing between these concepts in the months ahead.

I hope my remarks have been a little helpful in creating a perspective for thinking about the particularized pros and cons of the system, and for getting beneath the surface down to the real building blocks which we will all be confronting.

Emmette S. Redford has termed the dual system "competitive federalism" to distinguish it from "cooperative federalism" and this strikes me as an apt term.

However competitive it may be, and however competitive the various interests who will debate this issue may be, however, I suggest that we will all do better if we approach the question rationally.

You should understand, however, that I am taking the precaution of battening down the hatches for we share an interesting similarity. The creed of my home state of Alabama is "we dare defend our rights," and of course your own is "Our liberties we prize, our rights we will maintain." And I know you will!

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis