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[State-Federal duplication and the dual banking system]

Address by

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Director

before the

Conference of State Bank Supervisors,
Atlanta, Georgia

May 10, 1977

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Address By
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Director
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When I talk with businessmen, bankers, and consumer advocates around the country, I hear one persistent complaint: profound dissatisfaction with the pervasiveness of governmental intervention in our day-to-day affairs and with the reams and reams of paper that are required to effect even the simplest and least controversial of transactions. A recent Brookings Institution study points out that 53 "Executive Branch agencies and units....were created during the first term of President Nixon, (more) than in any other presidential term in the nation's history. Another 23 were created in 1973, the first year of the second Nixon term."

Although I am not optimistic about the prospect of reversing this trend, there is reason for hope. Increasingly, liberals and conservatives alike recognize that we have a real problem on our hands and that failure to deal with it threatens to disrupt our economy and stifle our society. This evolving concensus has led to interest in various governmental and regulatory reform strategies including "Sunset Legislation," zero-based budgeting, regulatory reorganization, and an increased reliance on economic incentives to replace detailed regulations. And, of course, President Carter's strong commitment to achieving efficient and effective government provides a strong leadership force.

The issues involved are not simple. Most informed people share the recognition that our economy is too large and complex to function properly without some governmental supervision or regulation. For example, while some might disagree with the direction of monetary policy at a particular time, few would deny the need for a mechanism to control the quantity of money in the system. Similarly, although one may disagree with the specific policies of many environmentalists, the absence of some controls over the disposal of commercial waste and other pollutants would lead to disastrous consequences in a highly industrialized society such as ours. And finally, by way of illustration, there is, I believe, general agreement that some surveillance and supervision of the operation of individual banks is required to avoid an excessive number of failures and the resulting economic instability.

Accordingly, the problem is not that regulation and supervision of economic and commercial affairs is inappropriate, but rather that regulation often outlives the problem it was intended to address; that we do not always take sufficient care to choose the least costly and drastic means to achieve the desired end; and that often, regulation results in unanticipated consequences which can be more severe than the problem which regulation sought to remedy.

It is not surprising, however, that these problems are so rarely dealt with effectively. All too often those who are regulated, while screaming loudest about the sanctity of an unfettered free enterprise system, grow comfortable in their regulated environment and resist mightily when any serious effort is made to deregulate. Similarly, regulatory bodies acquire a vested interest in their own existence and the "turf" which they regulate which prevents their objective assessment of the regulatory policies which they pursue. As a result, government agencies are often loath to engage in critical self-examination. And, finally, it must be acknowledged that while it is possible to deal with these issues with some ease in the abstract, real world solutions are not easy to produce. In part, this is a consequence of practical politics and the fact that any change in the framework of an industry's regulation may lead to significant short-run dislocations or adjustments costs. At least as important, however, is the simple fact that answers to many of these problems are extremely difficult to discover.

These factors provide a partial explanation of why bank regulatory reform efforts have failed to date and why the growth of government and regulatory agencies is seemingly inexorable. Notwithstanding the difficulties, however, I believe that it is important--and perhaps crucial--that bankers and bank regulators develop a systematic and reasoned approach to regulatory reform. In my judgment, the failure to develop such a positive approach will have several adverse consequences. A golden opportunity will be lost to deal in a meaningful way with the problems of excessive and inefficient regulation at both the state and federal levels and to highlight the unintended ill effects and hidden costs of regulation. Similarly, an opportunity will be lost to remedy certain demonstrable inadequacies in the present supervisory framework.

Today I do not intend to focus on the subject of bank regulatory reform generally, but rather a facet of that subject which is of special concern to this group and which, in my judgment, received far too little serious attention in Congress and the agencies during the 94th Congress--that is, the overlapping and, at times, conflicting relationships between state and federal bank regulation and supervision. It is conceded by all that extensive overlap of law and functions exists. Indeed, your counsel, Jim Bell, has been most happy to argue that the FDIC is only an insurance company--a position with which we, of course, take exception. What is not well known is the extent of the costs and problems that may flow from this duplication, or the gaps that may exist in regulation by virtue of tasks simply "falling between the cracks." And, conversely, we do not have a grasp of the benefits that may flow as well from this redundancy.

As I have suggested in the past, I believe that the relationship between the state and federal bank regulation cries out for rationalization to a far greater extent than does the framework at the federal level. Because I cannot now prove this case to my own satisfaction and because I am, quite frankly, not certain as to the appropriate solution to the problem which I perceive, I intend to propose to the FDIC Board that we sponsor a comprehensive and detailed examination of this subject.

At this juncture, I should digress for a moment to make clear that I do not mean to attack, explicitly or implicitly, the dual system of bank regulation and supervision and to explain why I think it important to develop new strategies aimed at assuming the continued vitality of that system. Indeed, I am opposed to consolidation of bank supervision and regulation at the federal level because I believe that the existence of regulatory choice implicit in our dual system is one of the primary reasons that we have a diverse, competitive and innovative banking system.

This is not to say that there is any magic in the notion of a dual banking system <u>per se</u>. Many countries get along quite well with a unitary system of banking. Indeed, many arguments on behalf of dual banking tend to get lost in rhetoric and, as a result, fail to make most effectively the case in its favor. Similarly, by our attachment to the rhetoric of dual banking, we may ignore the need to take the steps necessary to ensure its continued stability. Nor do I reject out of hand the arguments advanced by the proponents of consolidation. Indeed, consolidation at the federal level would result in certain economies, and, if nothing else, would make the system tidy and more comprehensible to those unfamiliar with its intricacies.

Nevertheless, I strongly favor and will argue vigorously for a bank regulatory system which maintains the concept of regulatory choice at the state and federal levels for two reasons. First of all, the system is in place and unlike many other regulatory structures in government, it is functioning effectively and has demonstrated the capacity to change--to, in effect, reform itself. Given this fact, it seems to me that those who argue against the efficacy of regulatory choice bear a strong burden of persuasion. Secondly, and perhaps more importantly, banking history demonstrates that the existence of regulatory alternatives provides, in part at least, one of the mechanisms which the regulatory reform movement seeks--a means of self-adjustment and self-reform. In effect, something like a market mechanism may be seen at work with good regulation driving out bad over the long haul.

Recent banking history is replete with examples of this phenomenon. Although many disagreed with the specifics of his decisions, it is clear, in retrospect, that Jim Saxon served the banking industry and the public well by allowing National banks to do things repugnant to his colleagues at the FDIC and the Federal Reserve Board. In effect, he helped take banking out of the conservatism that was a holdover from the Depression. Similarly, in recent months, while Congress has found itself unable to act, state legislatures and state regulators have taken the lead in pursuing alternative strategies of dealing with financial reform and electronic funds transfer systems. As a result, we have numerous laboratories whose experiments will provide insights as to the most nearly optimal approach. Also, I find it highly doubtful that a single banking agency would have felt the need to implement significant reform in its examination and supervisory procedures as did the Comptroller of the Currency's Office and, at least at this juncture, I think it is beneficial not harmful that the FDIC and the Comptroller's Office have different strategies for dealing with the problem of insider abuse.

Because of my views that regulatory choice is, on balance, beneficial, my purpose today in focusing upon the overlap between state and federal supervision and regulation is not to suggest that either the state or the federal government should retire from the field, but rather that we should begin a systematic examination of this relationship aimed at ensuring its continued vitality. This is especially important, from the point of view of state banking, given some of the forces at work in banking today. We are all aware, for example, of the Federal Reserve System's concern with continued attrition from the System. Because of this concern, the Fed is certain to come forward with a proposal aimed at minimizing attrition through the payment of interest on reserves probably coupled with a proposal for nation-wide NOW accounts. At least one observer--Carter Golembe--has pointed out that if the Fed is successful in minimizing costs of membership, then a powerful incentive will be created for banks to seek a national charter in order to avoid dealing with two regulators.

In my judgment, the best insurance we can have for the health of state banking is not a defensive or negative posture but rather an objective and creative, if at times painful, effort to revitalize the system. Although overlap between state and federal supervision has not been a focus of attention during the past three years, the problem has long been recognized. Indeed, traditionally, your own organization has been vigorous in calling for an end to overlap through the maximum withdrawal of the FDIC and the Fed from the field of supervision and regulation. In 1971, the CSBS report "Toward A More Responsive Regulatory Structure," which was submitted to the Hunt Commission recomme extensive withdrawal of the federal presence. The case was stated most eloquently, of course, by your general counsel, who argued at your Williamsburg conference in 1974 that:

> "We must not only halt the growth of, but initiate a roll-back of federal regulation over state banks. Our philosophical position is that there are two regulators, the Comptroller of the Currency and the state supervisors."

And further:

> "The Federal Reserve Board's charge is to direct monetary policy. The Federal Deposit Insurance Corporation is precisely that--an insurance company."

Others have addressed this question as well. Speaking before the Utah Bankers Convention early last summer, I argued:

> "In my judgment, questions pertaining to the structure of state banking belong to the states in a system of 'dual banking.' For example, I would favor an elimination of the statutory requirement that the FDIC approve branch applications. Rather, I would simply require that the FDIC be given reasonable notice with the expectation that the FDIC would proceed under its Section 8(b) if the proposed branch were imprudent and constituted an unsafe or unsound banking practice. Other areas where the states might appropriately assert supremacy are the areas of EFTS and consumer affairs. Recent efforts by state banking departments in both of these areas demonstrate the ability of state banking to assert positions of leadership. Needless to say, the case for this sort of federal deference to state regulation in any of these areas must be made to the Congress and in my judgment should be made as aggressively as possible."

At the same time, I made a parallel argument when I stated as to the subject of bank examination:

> "Quite frankly, I should acknowledge to you that while I support the withdrawal program and am guardedly optimistic with respect to its results, it is my view that other areas of regulation and supervision are far more likely candidates for the withdrawal of federal presence and the assertion of state authority. Congress has made quite plain to the banking agencies and especially to the FDIC, because of its peculiar responsibility to depositors, that they are to be held primarily accountable for the safety and sound-

ness of our nation's nearly 15,000 banks. The importance of this responsibility and the expectation of Congress that the agencies will carry it out has been underscored in recent months by concern for financial markets and for financial institutions generally. In the present atmosphere and in the foreseeable future, I view it as extremely unlikely that Congress would look favorably upon FDIC deference to the state in the area of bank examination and supervision for safety and soundness purposes. Moreover, it seems to me that in the area of safety and soundness, given the federal investment in this area already in place and likely to continue, state governments would be wiser to minimize their investment in examinations and audits which duplicate their efforts in areas in which the state governments have a comparative advantage and where diversity and experimentation are more desirable."

In addition, former FDIC Chairman Frank Wille, current FDIC Chairman Bob Barnett and former State Bank Superintendent, John Heimann, have addressed the question of state-federal duplication and have come forward with proposals. Frank Wille discussed the matter in the context of his plan for federal agency reorganization. Under Wille's plan, a proposed Federal Banking Board would have authority to defray the expenses of state banking departments which take over by contract any of the examination of supervisory functions of a federal supervisor of state banks. And, of course, former Chairman Wille and current Chairman Bob Barnett were instrumental in the development and implementation of the FDIC examination withdrawal program conducted in Iowa, Georgia, and Washington.

In testimony before the Senate Banking Committee on Senator Proxmire's reorganization package, then Superintendent Heimann urged federal funding of state supervisory efforts as a means of ensuring quality examination. The Heimann proposal was more detailed, providing for FDIC certification of the competence of state banking departments pursuant to federal statutory standards. Once certified, the banking department would function as the examining and supervisory authority for all state-chartered banking institutions in the state. Approval of a charter application by a certified banking department would result in automatic insurance by the FDIC.

A concrete effort to eliminate or minimize the overlap has recently been completed at the FDIC. As you may know, on February 1, 1974, the FDIC, in cooperation with CSBS and the states of Iowa, Washington, and Georgia, embarked upon a thirteen month program whereby it would withdraw from the examination a certain percentage of state nonmember banks in each of those states. The experiment was designed to study the implications of relying solely on state banking department examinations. At the beginning of 1975, the Corporation determined that fair and more comprehensive evaluation of the experiment could be made if two consecutive examinations were undertaken by each state banking department. Accordingly, the experiment was extended. In 1976, the FDIC conducted an examination of each of the banks which had been examined by the states during the preceeding two years, with the states examining those banks they had not examined in 1974 and 1975. The objectives of the 1976 FDIC examinations were to provide a basis for evaluating the experiment as well as assessing the condition of the examined banks. Early this year an analysis was made of each examination by the FDIC Division of Bank Supervision and an appraisal made of the experiment as a whole. Based upon the recommendations of its Division of Bank Supervision, the Corporation determined not to expand the withdrawal program on the basis that was pursued in the experiment. Rather, an attempt will be made to implement a "divided examination program" whereby examination and supervisory responsibilities continue to be shared but manpower is used more efficiently. An agreement to proceed in this fashion has been concluded in Georgia and it is anticipated that such agreements will be reached in other states.

Although such efforts as this and the suggestions of Frank Wille, John Heimann and myself are steps in the right direction, they do not begin to address in a comprehensive manner the possible problems posed by the relationship between state and federal bank regulation. Moreover, while I have throughout this discussion referred to the problems resulting from duplication and conflict inherent in this relationship, I have not yet made a systematic case for the proposition that the overlap involved creates serious problems.

It is possible, however, to identify some of the sources of serious concern. First of all, it is clear to me that there is no need for two competent agencies to examine and supervise safety and soundness of a single financial institution. Accordingly, either the state or federal government is in this case bearing unnecessary cost and wasting scarce resources which might be more efficiently used elsewhere. For example, both consumers and the financial community might profit if these scarce resources were concentrated on problems which are not addressed effectively at the federal level. And, conversely, by deferring to the states in areas where they have a comparative advantage, federal resources can more effectively be brought to bear on serious problems. Second, it also seems clear to me that, as Carter Golembe suggested, it is usually more costly and burdensome for a bank to deal with two regulators than one. And, third, in cases when problems arise, the need for two regulators to coordinate their actions sometimes means that a problem or violation is dealt with less vigorously and expeditiously than it might otherwise have been handled. We have found that the problem of coordination is especially severe in bank failure cases.

Although it is possible to outline these problems and possible sources of unnecessary cost, I must admit that I do not have a precise handle on the extent and costs involved. Nor am I certain that I have identified all the problems or given them proper weight. Moreover, while Frank Wille, John Heimann and I have suggested in a rough form some solutions to the problem, if there is one, these strategies obviously need to be spelled out in greater detail than they have been to date.

For these reasons, I intend, as I suggested earlier, to propose to the FDIC Board a comprehensive study which will attempt to address in an objective and systematic fashion the questions I have raised. Such a study would first of all attempt to describe in detail the relationship between state and federal bank supervision and regulation in order to pinpoint precisely the nature and extent of duplication and conflict that actually does exist in the system. Such a study would focus on the costs and burdens that flow from such redundancy as well as benefits that flow from the present system. Additionally, the study would seek to identify special problems that arise as a result of this unique partnership between the state and federal regulators. The goal of such a study would not be a development of one master plan as to how to rationalize this system but rather a series of options which might be pursued administratively, at the state or federal level, in the Congress on in state legislatures. It is my view that we should go forward with such a project because I believe that these issues are serious and because I believe quite sincerely that it is important to understand and to attempt to ensure the vitality of our dual system of bank regulation and supervision.