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# FDIC NEWS RELEASE

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Statement on

Federal Bank Commission Act of 1977
and
Federal Bank Examination Council Act

Presented to

Senate Committee on Banking, Housing and Urban Affairs
United States Senate

by

George A. LeMaistre, Chairman
Federal Deposit Insurance Corporation

September 16, 1977

Mr. Chairman, I welcome the opportunity to testify with respect to the Federal Bank Commission Act of 1977 (S. 684) and the Federal Bank Examination Council Act (S. 711).

I should emphasize at the outset that the FDIC is not wedded to the existing regulatory structure. We are quite prepared to see the powers and responsibilities of the agency changed significantly. It is our belief that we should work to construct a framework of supervision and regulation which will assure the health and stability of the financial system, facilitate financial innovation and afford appropriate protection for investors and consumers with the minimum necessary governmental intervention. Such a framework must take into account the dramatic changes that have occurred in recent years and must anticipate and accommodate the changes which are likely to occur during the next quarter century.

Needless to say, the subject of bank agency reorganization is not a new one. Indeed, the Federal Bank Commission Act is essentially the proposal made by the Brookings Institution in 1937 and again by former Federal Reserve Board Governor Robertson in 1962. Moreover, it is one among many proposals developed over the past forty years aimed at comprehensive reorganization of the bank regulatory and supervisory framework. Taken together, these proposals would seem to have raised every imaginable possibility for rearranging the functions of the three federal banking agencies.

Throughout the spirited and often quite heated debates that these proposals have aroused, two questions have been central: First, should the functions of federal bank supervision and regulation be consolidated in a single agency or remain dispersed? Second, what is the appropriate relationship between the formulation and implementation of monetary policy and bank supervision and regulation? It should be noted that these questions are independent and can be considered separately. While the Federal Bank Commission Act would centralize bank supervisory and regulatory functions, the Hunt Commission would have maintained a dispersed system at the federal level. Moreover, former FDIC Chairman Frank Wille developed a reasonable framework which consolidates some functions but retains the possibility of choice of regulatory systems at the federal level. Although these three proposals would remove the bank supervisory responsibilities from the Federal Reserve System, it has also been proposed that bank supervision be consolidated entirely or substantially within the central bank.

We at the FDIC have studied these two questions carefully during the past three years. In my testimony I have attempted to outline for you the arguments that have been advanced and our view as to their merits. For my own part, I have tentatively concluded that bank supervision and regulation should be divorced from the formulation and execution of monetary policy as proposed in the Federal Bank Commission Act, but that, while centralization is appropriate for certain functions, the public interest is better served if certain other functions are performed by alternative systems.

Notwithstanding the intensive analysis that has been focused upon the two central issues involving the allocation of functions among the three agencies which regulate commercial banks, I would recommend that the subject of comprehensive agency reorganization be deferred. My belief that such delay is advisable reflects the fact that the financial world and its regulatory environment have changed radically since the proposal before us was first advanced four decades ago. Indeed, the pace of change appears to be quickening. For example, it is no longer possible to think of "banking" as something done solely by institutions designated "commercial banks." In the 1930's, banks were banks, thrift institutions were thrift institutions and securities firms were securities firms. It was reasonable then to devise discrete regulatory systems, including one for commercial banks. Similarly, during the 1930's it was clear that the primary mission of the bank regulatory structure was the protection of the safety and soundness of the banking system and of individual banks. Since that time, the agencies have been assigned an increasingly diverse and sometimes potentially conflicting set of missions, including the administration of civil rights and consumer protection laws and greater emphasis on policing disclosure under the securities laws. That the simple world of the 1930's no longer exists means that the framework contemplated by the Federal Bank Commission Act may not be sufficiently broad to permit us to supervise and regulate depository institutions in a coherent and effective fashion.

Accordingly, I believe that prior to effecting any comprehensive reorganization of the bank regulatory functions Congress, the Administration and the agencies must address in disciplined fashion a series of further questions which should be answered if we are to devise a bank supervisory and regulatory framework suitable for the next quarter century. In the discussion which follows, I suggest some of these questions, analyze the two questions central to the Federal Bank Commission Act and spell out two recommendations for immediate action. Because the fragmentation of jurisdiction with respect to the supervision and regulation of bank holding company systems represents a serious problem which should be resolved promptly, I would place supervisory responsibility for the entire holding company with the agency which has primary jurisdiction over its lead bank. Secondly, I recommend enactment of a modified version of S. 711 which would include the Federal Home Loan Bank Board and the National Credit Union Administration.

Although I suggest deferral of comprehensive reorganization at this time, I hope to make it quite clear that I believe that there is a profound need to proceed seriously and with some dispatch. Indeed, the questions which I raise suggest a significantly more dramatic restructuring of bank regulatory functions than that envisioned by the Federal Bank Commission Act.

## I. Questions Which Ought to be Addressed by a Comprehensive Reorganization of Bank Supervision and Regulation at the Federal Level

### A. The implications of financial institution reform

Although comprehensive financial institution reform at the federal level has failed in the political arena, technological innovations, developments in the marketplace and action at the state level have tended to take us slowly but surely toward the world that the Hunt Commission envisioned. Mutual savings banks took the lead in this regard with the development of the NOW accounts and with such innovations as telephone transfers. The range of consumer and investment powers which the mutual savings bank industry has sought is already available to savings banks and their customers in many of the 17 states in which savings banks compete. In some states, present mutual savings bank powers, including interest-paying NOW accounts, actually exceed the powers recommended by the Hunt Commission Report. Moreover, passage of pending legislation providing for NOW accounts on a nationwide basis, if it should occur, would change dramatically the separation of functions among financial institutions.

Other institutions are also pushing vigorously at the traditional boundaries of their industries so that distinctions among financial institutions are increasingly blurred. For example, the expansion of credit union activity is having an increasingly important impact on the banking industry. The relative gains of credit unions in financial markets are likely to increase in the future as credit unions acquire important new powers. One of the most important initiatives is the expanding share draft program, although only 4 percent of federal credit unions currently operate such programs, with $200 million in share account liabilities. Another new power is the recently legislated increase in the permissible term to maturity for loans from 10 years to 30 years, which effectively allows credit unions to make mortgage loans. The acquisition of transaction accounts and the increased term to maturity will certainly enhance credit unions' ability to compete with other financial institutions.

In short, the various forms of financial intermediaries -- commercial banks, savings banks, credit unions and savings and loans -- are already and will increasingly be in direct competition with one another. Accordingly, it seems to me that an attempt to devise a regulatory structure that is appropriate in the coming years must necessarily deal explicity with the regulation of thrift institutions. It is for this reason that I recommend inclusion of the Federal Home Loan Bank Board and the National Credit Union Administration in the Council which would be established under S. 711.

B. The implications of competition from non-depository institutions

I would also argue that any attempt to devise a reorganization appropriate for the next 25 years should take into account other financial or commercial institutions, not usually conceived of as depository institutions, which are increasingly performing functions ordinarily associated with credit unions, savings and loans and banks. Failure to devise a regulatory structure that encompasses all institutions which perform similar functions is unfair to those institutions which compete within the strictures of a tightly regulated environment. In particular, I would call attention to arrangements such as the Merrill Lynch plan which allow customers to borrow, write checks and make VISA card purchases against interest-bearing funds held in margin accounts. Test marketing of this plan begins this month. Similarly, large retail chains have the capability and may choose to offer services which have traditionally been the province of commercial banks.

C. The implications of technological innovation in electronic funds transfer systems

The development of electronic funds transfer systems will pose a series of special problems for the bank regulatory framework involving bank structure, safety and soundness, and bank security. Moreover, electronic funds transfer systems promise to further blur the distinctions among traditional financial intermediaries as well as the distinction between these institutions and other firms. The regulatory problems thus posed will be further complicated as sharing and joint ventures increase. Moreover, there still exist significant questions as to what role the government itself should play in the development of these systems. Such developments pose questions of significance for the shape of our regulatory framework.

D. The appropriate locus of the investor protection function

An area of redundancy and conflict in the federal bank regulatory apparatus underscored by events of the past three years is the protection of investors through the enforcement of securities laws. Congress made a determination that banks should be exempt from the registration requirements of the Securities Exchange Act of 1933. Whatever the reasons underlying this exemption or its merits, the rapid evolution of the holding company as a dominant banking form has served to nullify the advisability of continuing the exemption. So long as holding company systems finance through the holding company rather than the bank -- and that has been one of the attractive features of the mechanism -- bank exemption from SEC jurisdiction is virtually meaningless for banks in holding company systems.

The fact that the SEC has securities law jurisdiction over bank holding companies while the bank agencies have jurisdiction over banks within such systems has two ill effects. The necessity of dealing with two agencies with respect to disclosure matters may prove costly and burdensome to the regulated institution, and may result in duplication of effort and excessive cost within the government. Even more troubling, perhaps, have been the sometimes bitter conflicts between the SEC and the banking agencies with respect to questions of policy.

It seems to me that Congress should face up to this fundamental anomaly in the law in the context of a comprehensive reorganization effort. Responsibility for enforcement of the securities laws should be vested in either the SEC or a banking agency or agencies. The failure to do so, it seems to me, will lead to further duplication of time and effort as well as further conflict and confusion.

E. The appropriate locus of consumer protection and civil rights functions

Since 1968, the banking agencies have been assigned increasing responsibilities in the civil rights and consumer protection areas. The agencies have been subject to serious criticism by the Congress and consumer and civil rights groups on the grounds that they have not been vigorous in enforcement. Although significant and demonstrable strides have been made, the feeling continues that the banking agencies are not sufficiently mindful of their responsibilities in these fields. Paradoxically, many bankers argue that the enforcement of these laws through the examination process subjects them unfairly to far more rigorous oversight than other institutions.

Some argue that the primary mission of bank regulators should be assuring the safety and soundness of the banks and that examining for compliance with the consumer and civil rights laws absorbs needed resources and conflicts with their safety and soundness mission. They believe that the Federal Trade Commission should be assigned responsibility for administration of the consumer laws. Others argue rather strenuously that the banking agencies are the most effective possible vehicle for the protection of consumer and civil rights.

For my own part, I am of the view that the banking agencies are the most effective vehicle for the enforcement of the civil rights and consumer protection statutes, both because of their expertise and because of the regular examination process. On the other hand, there is some risk that a banking agency whose primary concerns are "safety and soundness" and "competition" may not meet its responsibility for enforcement of consumer and civil rights statutes as well as an agency more clearly dedicated to those missions. In any event, I believe that Congress should consider the assignment of these functions in the course of a comprehensive review of the regulatory framework. If it is determined that the bank regulatory framework should be the locus of these functions, then certain other functions, including consumer protection responsibilities vis-a-vis non-bank holding company subsidiaries, presently in the hands of the FTC, and certain civil rights responsibilities currently in the hands of HUD, should be transferred to the bank regulatory framework.

F. The relationship of state and federal regulation and supervision

Still another question which has an important and direct bearing on the appropriate shape of the federal regulatory structure is the relationship between state and federal bank regulation. In my judgment, this relationship cries out for rationalization to a far greater extent than does the framework at the federal level. For this reason I proposed and, on August 29 of this year, the Board of Directors of the FDIC commissioned a study to analyze and appraise the system of state and federal bank regulation. The study will assess the costs and benefits of this overlapping structure and will develop recommendations for its improvement. Even though the focus of this study is not upon the interaction of the federal agencies, the peculiar partnership that exists between state and federal regulation means that its conclusions are likely to have significant implications for the structure of federal regulation as well.

II. Relationship between the Formulation and Implementation of Monetary Policy and Bank Supervision and Regulation

The Federal Bank Commission Act would separate bank and bank holding company supervision and regulation from the monetary policy function. In your letter inviting me to testify, Mr. Chairman, you specifically requested that I address the matter of what role the Federal Reserve System should have in bank and bank holding company supervision and regulation.

Many authorities (including some previously associated with the Federal Reserve System) have argued that substantial benefits would be gained by separating bank supervision and regulation from the formation and implementation of monetary policy and that the costs of such separation would be negligible. On the other hand, representatives of the Federal Reserve System argue that significant supervisory and regulatory responsibilities are required for the effective conduct of monetary policy. They argue as well that an understanding of the nuances of monetary policy and of developments in the economy facilitate bank supervision.

Three major arguments have been advanced in support of the removal of the Federal Reserve System from bank supervision and regulation. First, it has been argued that the Federal Reserve's responsibility for bank supervision diverts attention from monetary policy formation which may reduce its effectiveness in implementing monetary policy. Former Federal Reserve Board Governor James Robertson voiced this concern in stating:

> As a practical matter, I believe it would be seriously detrimental to place in the Board the important additional responsibilities that would accompany unification. There are limits to a man's ability effectively to perform his assigned duties. In our complex society, merely keeping informed of what is going on in the national economy is becoming more and more difficult. Developing and implementing appropriate monetary policy at a given time require consideration and evaluation of the significance of an enormous volume of available data and their interrelationships. The responsibilities are of such magnitude that the Board should not be also burdened with the performance of bank supervisory functions. Supervision is too important a function in itself to be the Federal Reserve's part-time job.

This argument has assumed greater importance today than when first made by Governor Robertson because of the Federal Reserve's mushrooming responsibility under the civil rights and consumer protection laws and because of the ever increasing burden of holding company supervison and regulation.

Second, some observers find the existing concentration of power within the Federal Reserve System disturbing, given its insulation from the political process, and would favor separation of the supervisory and monetary policy functions on this ground. Even supporters of consolidation within the Board of Governors recognize the potential problem, as Governor Holland indicated in suggesting that a partial consolidation "would accomplish a good deal of what is claimed would be accomplished by a complete consolidation of Federal bank supervisory functions, without some of the dangers of complete unification...."

Third, it is argued that when the implementation of monetary policy goals and bank supervision are combined, the former will inevitably take precedence, leading to inconsistent and inequitable bank supervision. For example, it is argued that the monetary authority would be loathe to restrain the aggressive policies of a group of overextended money center institutions when monetary policy goals are aimed at credit expansion. Conversely, it is argued that the Federal Reserve Board might move to check bank holding company expansion on safety and soundness grounds when its actual reason is to effect a restrictive monetary policy. Events during the period 1971-1975 are cited to support this proposition. Many, including former FDIC Chairman Frank Wille, believe this inappropriate, arguing that bank supervision and regulation should be based upon an independent appraisal of the condition of the bank and not upon the monetary goals of the moment. Former FDIC Chairman Wille concisely stated the case as follows:

> The basic problem, of course, is that where the implementation of monetary policy goals is combined with bank regulation and

supervision, the former will always be viewed as more important than the latter and the temptation or threat is ever present to use the powers of regulation and supervision to reward banks for their cooperation or to penalize banks for their lack of cooperation with the Board's most recent view of its monetary policy goals. Since those goals change with some frequency, the likelihood of a consistent, evenhanded approach to matters of bank regulation and supervision over any length of time is very much in doubt. Whereas prior to 1970, this was a special concern only of large State member banks which the Federal Reserve System actually examined or of member banks forced to the discount window, it is now the concern of every bank in a holding company system.

Although I believe that the first and third of these arguments have some merit, I think that the determination of whether or not to separate the formulation and implementation of monetary policy from the supervision and regulation of banks and bank holding companies must ultimately turn on the merits of the case which the Federal Reserve Board makes for the proposition that supervisory and regulatory responsibilities are <u>necessary</u> for the effective conduct of monetary policy.

The Federal Reserve has stated two reasons. First of all, the Board of Governors has contended that information gained directly from examination and supervision of banks provides a useful input in the formulation of monetary policy. The argument implies that supervisory responsibilities provide the Board with a tangible feel for events in the banking system. Former Governor Holland argued in testimony before this Committee that "examiner asset evaluations supply firsthand knowledge of the changing quality of credit.... This provides valuable supplements to the meaning of the quantitative statistics on monetary and credit aggregates."

This argument may be challenged on at least three grounds. First of all, the Federal Reserve does not need to be engaged actively in supervision to obtain such information. It could be attained easily through conversations with supervisory agencies or through participation on their boards. Alternatively, the Board could be given authority to collect information reflecting credit quality in other ways that do not involve the full panoply of supervisory responsibilities. Second, even if monetary policy benefits from information provided firsthand through direct supervision, which cannot be obtained in other ways, one still must consider whether the value of such information outweighs the very substantial costs in terms of time and resources that are consumed by supervisory and regulatory responsibilities. Finally, many analysts question whether such information can possibly be relevant given the lags between changes in credit quality and the examination, and between events in the economy and changes in credit quality.

The second reason ordinarily given for the Federal Reserve's retention of supervisory and regulatory responsibilities is, in effect, that they are mutually reenforcing. Again, testifying before this Committee, then Governor Holland asserted:

> Now more than ever, the Federal Reserve's role as monetary policymaker and as lender of last resort interacts with the effects of prevailing bank supervisory and regulatory policies. Each of these policies increasingly influences the effectiveness of the other. To divorce them is to weaken both.

Governor Holland argued by way of example that if the bank supervisor alters bank capital or liquidity standards "at an inopportune moment, he can dilute or frustrate for a time the thrust of monetary policy."

The difficulty with this position is relatively straightforward and it is derived from former Chairman Wille's arguments. Sometimes objective supervisory standards will and should run counter to the thrust of monetary policy and will, therefore, dilute or tend to frustrate it. This will be the case whether or not supervision is within or outside of the Federal Reserve System unless the Board is really arguing that supervision and regulation ought to be used to facilitate the implementation of monetary policy. This, of course, would be objected to by those who believe in consistent and equitable supervision and regulation and by monetarists who would argue that the attempt to use such a tool is a wholly inappropriate and ultimately an ineffective way to conduct monetary policy. One might, however, accept the Board's argument if it could be demonstrated that the alteration of supervisory standards is an especially efficient lever vis-a-vis money supply control -- one which is truly necessary.

Thus far, I am unpersuaded by the case put forward by the Federal Reserve against this central feature of the Federal Bank Commission Act. Furthermore, I believe some benefits will be gained from the functional separation of supervision and monetary policy. However, as I indicated at the outset, my conclusion in this regard is tentative. I have an open mind on this issue because the arguments made to date have been largely rhetorical and I am confident that concrete evidence and significantly more vigorous analysis can be brought to bear on this subject by the Federal Reserve Board and others.

## III. Should All the Functions of Bank and Bank Holding Company Regulation and Supervision be Consolidated in a Single Agency?

The second central issue raised by the Federal Bank Commission Act is whether bank and bank holding company regulation at the federal level should be consolidated in a single agency. As I indicated at the outset, I am of the view that it would be unwise to centralize all bank regulatory functions in a single agency. This view arises out of my judgment that the existence of alternative regulatory systems gives rise, to a much greater degree, to constructive innovation in regulation and in financial services than it does to regulatory "laxity." That is, I believe that the existence of some degree of regulatory choice provides a better mechanism of regulatory reform than would consolidation of regulatory and supervisory responsibility within a single agency. Nevertheless, I am well aware that there are respectable arguments to be made for the proposition that some or all of the functions of bank regulation should be consolidated.

It has been argued that:

- consolidation would lead to economy and efficiency of operation
- consolidation would eliminate certain frictions and practical problems
- consolidation would facilitate the handling of distressed bank cases and bank failures
- consolidation would result in uniformity of approach and eliminate certain inequities
- consolidation is necessary to eliminate a "competition in laxity"
- consolidation would improve the supervision and regulation of bank holding company systems.

Ultimately, it seems to me that the decision to centralize turns on the question of whether, on balance, a system of divided or fragmented regulation leads to "laxity" detrimental to the public interest, or whether it results in a more dynamic and effective system of regulation. I am of the latter view believing that the benefits of such a system are substantial. By contrast, the benefits -- largely of efficiency and economy -- which would flow from consolidation are modest or may be obtained without centralizing all regulatory functions in a single agency.

As I indicated at the outset, the Federal Bank Commission Act does address what I consider to be the most immediately pressing problem associated with the present regulatory structure -- the fragmented regulation of holding company systems. Because I believe that this problem can and should be dealt with without a comprehensive reorganization of the regulatory structure, I shall discuss this problem and my proposed resolution separately. Before doing so, I shall examine and evaluate the arguments which favor centralization of bank regulatory functions.

A. Economy and efficiency of operation

Consolidation would lead to economies by eliminating the duplication of some functions. Also, the larger scope of a single agency may afford new possibilities for division of labor and specialization which will result in additional economies. In addressing the Federal Bank Commission proposal, the FDIC has attempted to identify and weigh the importance of the economies that would flow from consolidation in a single agency.

Duplication is particularly expensive in certain areas including, for example, maintenance of sophisticated computer equipment, employment and training of highly specialized personnel, data collection and data processing. Economies could be achieved by combining legal, research, training and other Washington office functions. Economies also would flow from the elimination of senior agency staff time spent communicating and keeping current with the activities of the other agencies. Considerable time presently spent in formulating policy and regulations would be saved.

Also, more efficient use could be made of examiner time and talent. Travel time of examiners could be reduced because the number of financial institutions in any geographic area would increase substantially. A single agency could also make more efficient use of specialized expertise to handle complicated credits and to concentrate on such areas as trust activities, international departments and foreign offices of financial institutions, data processing and other areas of automated activity and compliance with federal and state statutes in the consumer protection area. A single agency would eliminate differences in reports filed by financial institutions, thereby eliminating some duplication and redundant effort in administering and processing such reports. Consolidation of training programs would lead to some economies and would make it more feasible to develop advanced and specialized training programs.

Notwithstanding the benefits to be gained from consolidation in these areas, it should be noted that bank examination, the activity consuming the bulk of agency resources, would be affected little by consolidation. Bank examinations are labor intensive and in this area each of the agencies has reached a size in which most economies of scale have been realized. Our analysis of this function showed that consolidation is highly unlikely to affect very greatly the personnel requirements for the examining force or result in significant cost savings.

Thus, while some savings would undoubtedly result from consolidation of the three agencies, these savings would not be so great as one might initially imagine. Moreover, many of the economies which would result from consolidation in a single agency could be achieved through voluntary cooperation or through the sort of body envisioned in S. 711.

B. Frictions and practical problems

Consolidation may eliminate existing frictions in communication and coordination. This would be particularly beneficial in the area of problem bank cases and bank holding company supervision. It would also be useful in the drafting of regulations and in dealing with complex problems such as the development of electronic funds transfer systems. It would alleviate difficulties sometimes encountered in evaluating the soundness of the loans made by several different financial institutions to a single, nationally based company. A single agency would achieve a unified approach to dealing with foreign banking institutions and problems of foreign lending. Furthermore, the administration of a single agency, and oversight by the Congress, the Executive Branch, and the public would be greatly simplified. The public would not be confused about the agency to which it should direct an inquiry. Congressional requests for information would no longer have to be coordinated with several agencies.

C. The handling of distressed bank cases and bank failures

The existing bank regulatory framework does not delineate clearly, either by statute or custom, the division of authority and responsibility in distress cases. Lack of clarity as to jurisdiction could lead to serious problems in communicating information and in coordinating activities. Consider, for example, the easily imagined case in which a national bank that is a lead bank in a holding company system is in the throes of a liquidity crisis and likely but not certain to fail. The Comptroller of the Currency as charterer would be directly involved in seeking a solution to the problem short of failure and would be concerned as to when an insolvency determination is required. The Federal Reserve would be involved as supervisor of the holding company and as potential source of liquidity through the discount window. Finally, the FDIC as insurer and potential liquidator would be seeking, within statutory limits, to formulate the resolution which would be least disruptive to the community involved.

Needless to say, the potential for confusion, conflict and delay is substantial. Indeed, it has been asserted that the protracted resolution of the Franklin National Bank case was the result of the regulatory structure and, as one participant in that case, I am certain that there is an element of truth to that assertion. Comparable problems have arisen in other major bank failures.

Accordingly, it is fair to say that consolidation would facilitate the handling of bank failures at the federal level in some measure. (It should, however, be noted that more serious problems arise in dealing with state authorities in state bank failures.) The benefits to be gained are not in my judgment sufficiently great as to provide a compelling case for consolidating the banking agencies. Moreover, notwithstanding some conflict and delay, major bank failures have been handled with a minimum of ill effects.

D. Uniformity of approach and elimination of inequities

Differences in regulation, examination standards and reporting requirements among the agencies lead to different treatment of persons and institutions similarly situated, sometimes resulting in significant inequities. A single agency would bring uniform treatment to all financial institutions in such matters as rules, regulations, standards and procedures. Banks would also be subject to greater uniformity with respect to loan classifications, policies on capital adequacy and other areas related to bank examinations and supervisory policy. Holding company supervision and merger policy are two areas where a uniform approach is highly desirable.

While consolidation undoubtedly will result in improvements in uniformity of approach and eliminate some inequities, differences in the approach of various individuals and groups within an agency may be as great as the differences in approach among the agencies. For example, policy differences tend to exist among the different regional offices of the FDIC, partly as a result of different personal styles and partly as a result of unique local circumstances. Accordingy, it should not be expected that consolidation would necessarily bring about complete uniformity of approach.

E. "Competition in laxity" vs the benefits of dispersed regulation

It should be obvious at this juncture that the proposal to consolidate some or all of the functions of bank supervision and regulation may have some merit. I have not, however, discussed the argument most often relied upon by proponents of consolidation in a single agency. This argument is grounded in the notion that the existence of regulatory choice allows bankers to play regulators off against one another in order to obtain less vigorous regulation. In short, it is asserted, the possibility of regulatory choice leads to a "competition in laxity" among the regulators.

Opening hearings on the Federal Bank Commission Act on October 31, 1975, Mr. Chairman, you stated the argument well that

> . . . there's a strong tendency for the regulatory agencies to be far more lenient, too lenient, too permissive. They fail to exert the kind of discipline and stringency in their examination than they would if they did not have at least the recognition of the fact that if they are too strict and too tough that they will lose some of the banks because, of course, banks are free to move from being State banks to national banks, to State member banks to State nonmember banks wherever the jurisdiction would be lightest and easiest and the most permissive.

Several points are often cited as support for this argument. During the early 1960's, Comptroller of the Currency James Saxon expanded the powers of national banks through a series of rulings, and was quite liberal in granting national bank charters and branch applications -- a sharp reversal of the policies of his immediate predecessors. These policies provoked sharp criticism, particularly from the Federal Reserve Board, and several of his rulings were overturned in the courts.

Recent merger decisions by the Office of the Comptroller have been used to support the "competition in laxity" argument. The Comptroller has been significantly more willing to grant merger applications than the FDIC and the Federal Reserve Board, and many have been granted in the face of adverse findings by the Justice Department. The tendency has been so pronounced that some state banks have shifted to national charters in order to obtain a merger approval. In addition to these illustrations, it has also been suggested by some that one or more of the recent large bank failures may have, at least partly, been the result of competition in laxity. Finally, while the charges have not been documented, it has been asserted that the Federal Reserve System's concern with membership attrition has led to a tempering of regulatory zeal.

From these illustrations, it is argued that regulators unduly concerned with maintaining their market share of regulatees have acted in ways contrary to the public interest. Although a given regulator may have been concerned with maintaining his share of the market for regulatees, I do not believe that this concern has been a significant factor in bank regulation. Perhaps I am naive, but in <u>no instance</u> have I even suspected that a regulator was motivated by such a concern during the time that I have been in Washington. For example, while it is true that the Comptroller's merger policy was more favorable to mergers than that of the FDIC during the early 1970's, I am convinced that this reflected legitimate differences over policy and the law and not any effort for agency self-aggrandizement.

I am troubled by the "laxity" argument on one further score. I am well aware of the effectiveness of a pithy and evocative phrase. And, I have been guilty of using such phrases in ways that may attractively misrepresent the reality which I am describing. Nevertheless, it is my sincere hope that we can and should put behind us the use of the phrase "competition in laxity" in favor of hard-nosed and objective analysis. I say this for a very simple reason. In its implication, the phrase is inaccurate and grossly unfair to the men and women who supervise and regulate banks and who use their best judgment and ability to carry out the mandate of Congress and act in the public interest. Moreover, its usage is in my opinion insensitive, and I challenge those who resort to it to spend some time with bank regulators to see whether they compete in "laxity."

Indeed, although use of the phrase "competition in excellence" represents resort to platitude as well, my experience at the FDIC indicates that professional pride is a strong motivating force. FDIC examiners believe that they examine and supervise banks more effectively than the examiners of the other two agencies, and they work hard to assure that they do. Moreover, unless I misjudge my colleagues on the panel, I am quite certain that our own professional pride leads us to compete in ways that redound to the public benefit.

Finally, and most importantly, banking history demonstrates conclusively 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. In short, I believe that alternative regulatory systems serve a regulatory reform function analogous to zero-base budgeting and "sunset" laws.

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 and bank regulation out of the conservatism that was a holdover from the Depression. Moreover, I find it highly doubtful that a single banking agency would have felt the need to implement reforms in its examination and supervisory procedures as significant as those recently adopted by the Comptroller of the Currency as a result of the Haskins and Sells study of that office. 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. Moreover, while one might argue that the development of different early warning systems involves costly duplication, I believe that the competition which I have watched in this area is healthy and in the best interest of the banking system.

In addition to the regulatory reform function which is served by a system involving regulatory alternatives, the existence of more than one banking agency provides the Congress and the public with informed critics and alternative sources of analysis. For example, regardless of the relative merits of the respective positions, I believe that it was a healthy and vital sign that the FDIC was able to comment on the bill proposed by the Federal Reserve and the Administration providing, among other things, for the expansion of NOW accounts nationwide and for the payment of interest on reserves.

Finally, and in the same vein, the existence of more than one agency responsible for safety and soundness provides a backup or watch-dog which, rather than allowing or encouraging laxity, tends to deter it. Although the FDIC has rarely employed its standby authority to examine member banks, this tool provides the insurer of banks with the means to assure the accountability of the other agencies.

## IV. Bank Holding Company Regulation and Supervision

In my opinion the most serious inadequacy in the present regulatory framework at the federal level is the fragmentation of bank holding company supervision. Recent events have illustrated that the existing framework is not only unduly costly because of the overlapping and conflicting jurisdictions involved but also simply has not functioned properly in some instances. In three of our largest bank failures -- the insolvencies of Hamilton National Bank of Chattanooga and the American City Bank of Milwaukee and the distressed merger of the Palmer National Bank of Sarasota, Florida -- the cause was rather massive unsafe and unsound lending practices occurring in the essentially unsupervised environment of a non-banking holding company affiliate. The failure of the Hamilton Bank is perhaps the most graphic case. But for the $80 million in mortgages initiated by its Atlanta-based mortgage company affiliate, and then dumped on the bank when things went bad, the Hamilton Bank probably would be in existence today.

These cases illustrate two points which should be recognized by both the banking agencies and the Congress. First of all, the notion that one segment of a holding company system can be insulated from the remainder of the system is quite simply untrue. It is the worst form of self-deception to think that the lead bank in a holding company is in a safe and sound condition because its last examination was satisfactory, if other facets of the holding company system are not undergoing equally rigorous scrutiny. My point is that when bank holding companies were allowed to proceed in a manner that would be unacceptable in a commercial bank, some of them were encouraged, in effect, to undertake enormous risk.

The second point flows from the first, that is, it simply makes no sense for as many as four bank regulatory agencies to have safety and soundness jurisdiction over various segments of an integrated business enterprise. Inevitably, this approach will be at times conflicting and uncoordinated.

During the Congressional debate over the 1970 Amendments to the Bank Holding Company Act of 1956, holding company safety and soundness regulation and supervision were largely disregarded. The emphasis at that time was on providing safeguards against undue concentration of economic power stemming from bank holding company acquisitions of banking and non-banking subsidiaries. For example, in testimony on the 1970 Amendments before the Senate Banking and Currency Committee, Charls Walker, Under Secretary of the Treasury, stated that legislation was required to stop the trend toward the merging of banking and commerce that was taking place through the vehicle of the one-bank holding company. Federal Reserve Board Chairman Arthur Burns voiced similar concern. Although there was discussion during consideration of the 1970 Amendments about dispersing supervision and regulation of bank holding companies among the three federal bank regulatory agencies, the emphasis on the competitive and banking structure aspects of the bank holding company movement, coupled with the Federal Reserve's responsibility for administering the 1956 Bank Holding Company Act, led the Congress ultimately to delegate responsibility for administering the 1970 Amendments to the Federal Reserve System.

That such little consideration was given to the consequences of fragmenting responsibility over the different segments of a holding company system probably reflected, in part, the prevailing theory that the respective entities within a system could be effectively insulated from troubles elsewhere in the system. It also may have reflected the notion that the larger institutions in the holding company system, like the lead bank, would be a source of strength for all the components of the system. Events since the passage of the 1970 Amendments have demonstrated flaws in these assumptions and the inherent weakness of the fragmented regulatory framework supervising the various components of a bank holding company system. In spite of the rhetoric about the legal separateness of each entity within the bank holding company, it has become more and more apparent as we have gained experience that a bank holding company should be regarded as a single, integrated unit.

Even if it were not possible to illustrate the adverse consequences of the present framework in concrete cases such as the Hamilton failure, the present framework should be rejected both because of the governmental waste that results from the unnecessary duplication of effort and because of the burden imposed upon the banker who must deal with four bank regulators as well as the SEC, the Justice Department, the FTC and miscellaneous other regulatory bodies. In my judgment, this problem should be remedied immediately by charging the supervisor of the lead bank in a holding company system with the primary supervisory responsibility for the entire system. I would not at this time, however, shift the Federal Reserve Board's present role in determining permissible activities for bank holding companies. Nor would I shift responsibility for approving holding company formations and acquisitions.

V. <u>The Federal Bank Examination Council Act (S. 711)</u>

S. 711 would establish a Federal Bank Examination Council to prescribe uniform standards and procedures for the examination of commercial banks by the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve System. The Council might also make recommendations to promote uniformity in bank supervision. In addition to establishing uniform examination standards, the Council would, under the proposed legislation, conduct schools for federal examiners, which would be open to state bank examiners, and would develop uniform reporting systems for banks, bank holding companies and non-bank subsidiaries. In addition, the legislation would provide for establishment of a liaison committee on uniform standards and procedures by state and federal bank supervisory agencies. The Chairman of the Board of Governors of the Federal Reserve System would be Chairman of the Council. With certain modifications, I support the essential thrust of this legislation.

First of all, I oppose the requirement that uniform examination and supervisory standards be established. As I have indicated, one of the great virtues of our existing regulatory structure is the possibility for creativity and innovation. The examination process is one of those activities that benefits most from competition and experimentation among bank regulators. A study of bank examination would reveal that numerous innovations, changes and improvements have been proposed and many have been adopted during the past four years. I, for one, believe that this would have been less likely to have occurred if uniformity had been mandated. For this reason, I strongly recommend that the Council perform advisory, coordinating and watchdog functions and that it not be required to set uniform standards.

Second, I would assign to the Council the functions of the existing Interagency Coordinating Committee and would add the Federal Home Loan Bank Board and the National Credit Union Administration to the Council.

As I indicated at the outset, I believe that these two agencies must be included in any effort to reorganize the banking agencies.

Third, I oppose designating the Chairman of the Federal Reserve Board as Chairman of the Council for two reasons. First of all, I believe that the Chairman should be able to devote considerable time and effort to the activities of the Council and I seriously doubt that the Chairman of the Board of Governors would have time to do so. And second, with respect to supervisory matters, I can see no special advantage or expertise that the Federal Reserve System possesses over the other agencies that should lead to the designation of its Chairman as Chairman of the Council.

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