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CREATIVE TENSION IN BANKING

Remarks of

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CREATIVE TENSION IN BANKING

One of the most alluring of ideas is the serenity of purity. In homogeneity the tension of forces with conflicting ideas, backgrounds and aims is eliminated, all strive towards the same goals, and there are no cross currents to confuse and disorder movement.

But it seems apparent from history that whatever genius homo we hope sapiens has in him is fed and activated less by regularity, symmetry and homogeneity than by the tensions and uncertainties of cross currents, opposing ideas, freedom to innovate, the irritation and challenge of differences, all of it rolled up, perhaps, in the word we use as freely as we violate its concept: competition. We appear to respond creatively to the tensions of competitive differences-- hybrid races, hybrid cultures and societies, hybrid languages show a vigor and innovativeness that sameness does not seem able to match. Yet, we shrink from the clash and breakages of competition, and we find it very hard to avoid the temptation of imposing upon ourselves a tranquilizing dose of protection from the confusion, distractions and inefficiencies that accompany free and active competitive differences.

I have ventured into this bit of philosophizing not as an abstract proposition--and certainly not as a prescription for disorder: I am talking about free competition under the law, that is, creative tension.

My objective is to speak to the arguments of those who would prescribe for banking one system, one set of rules, one regulator and one form of entry and who, in defense of their position, point to wasteful duplication, confusing overlaps of jurisdictions, contrary rules, and conflicts of view among bank regulators empowered by different arms of government.

In my opinion, this is a view that is contrary to the lessons of history and that could lead us, in the name of a quiet life, into a banking system lacking in incentives, sinking into the lassitude of a regulatory captive, increasingly a creature of government rather than a vigorous and vital part of a competitive economic system, and, as such, a drag on the industry and commerce that banking is supposed to provide with financial innovation and stimulation.

My view is that as we have benefited from pluralism in America in so many other ways, we also benefit in banking from pluralism of bank chartering and regulation. However, as you will see, I do not carry this to pluralism of responsibility in banking.

You have probably noted by now that I have not been using the phrase "dual banking system." I am not doing so because I think it describes something that does not exist. We have a single system of banks in our national financial system, all serving the same ends: the need of individuals, commerce, other financial institutions and governments for the efficient marshalling of savings, for lending and investment, for effecting payments quickly and cheaply, for orderly creation of credit and for a repository of our funds.

Dualism in banking comes in, not at the level of the operations of banks, but at the governmental level, that is, at the level of bank chartering and bank supervision.

There is, then, instead of a dual banking system a dualism of public oversight of banking. New banks have the choice of being chartered by either State or national supervisors. Existing banks are free to change from one type of charter to the other. There is, in fact, a pluralism, rather than a duality, of choices for banks in the type of regulation that may apply to them. National banks are subject to the supervision of the Comptroller; uninsured State chartered banks to that of the State only, while insured State banks are subject to regulations of the FDIC and the State. If they choose to be members of the Federal Reserve System State banks are subject to Federal Reserve supervision.

This complex system of a single, very large commercial banking system -- over 14,000 banks -- serving the financial needs of a huge and populous nation, with many diverse regional characteristics, is the result of an evolutionary process dating back at least to Revolutionary times.

The First Bank of the United States was chartered in 1791 with \$10 million capital. It had an immediate and unfriendly impact on State banks, due to its policy of requiring redemption of State bank notes in its possession for hard currency, in effect putting many small banks out

of business. Not very surprisingly, Congress refused to renew the First Bank's charter in 1811. There followed a period of undisciplined bank chartering, and bank note emission, that led to chartering of the Second Bank of the United States in 1816. But the Second Bank went back to the strong arm methods of disciplining banking, and in 1836 President Jackson -- as he had promised his capital-hungry frontier constituency -- vetoed the Second Bank out of existence. State banks again reigned supreme until the 1860's, when, due to pressures of financing the Civil War, the Congress passed The National Currency Act and the National Banking Act. It was here that dual oversight of banking as we know it, and what is called the dual banking system, were born, for these Acts established the Comptroller of the Currency in competition with State bank supervisors.

However, no uniform national paper currency was circulated, and the notes of individual banks were used as a principal medium of exchange. To make the national banking system more attractive, a 10 per cent tax was placed on State bank notes, and by 1870 there were 1,612 national banks compared to only 325 State banks. The tax eventually resulted, however, not in the elimination of State banks but in the rise of checking accounts, since checks were not taxed. State banking prospered again on this basis. Checking not only allowed remaining State chartered banks to compete, but was so attractive that by 1893 national banks were again in the minority. These episodes provide an example of how banking has adapted to survive major changes in the regulatory environment.

The Federal Reserve was created in 1913 "to . . . furnish an elastic currency, to afford means of rediscounting commercial paper (and) to establish a more effective supervision of banking in the United States" among other purposes. Its establishment was motivated by the money panics and succeeding depressions of the preceding 25 years. The Federal Reserve System's creation added to the saga of the State versus Federal regulation of banking, but it did not essentially alter the competing chartering and supervision systems dating from the Civil War.

The Banking Acts of 1933 and 1935, and the Bank Holding Company Act of 1956 and its revisions through 1970 completed the present basic regulatory structure. These Acts enlarged Federal Reserve authority and established the Federal Deposit Insurance Corporation. The FDIC has had a great impact on dual bank supervision, since a bank can rarely hope to be successful without FDIC deposit insurance. Thus, a new State bank must for all practical purposes obtain Federal insurance.

Consequently, since the FDIC was established, a cooperative State-Federal bank supervisory system has come into being, bridging many difficulties and concepts. This has, in effect, been extended by the establishment, in 1965, of the Inter Agency Coordinating Committee in which the FDIC, the Comptroller, the Federal Reserve and the Federal Home Loan Bank Board consult upon policy.

Thus, the dual bank supervisory system, as we know it, developed by an evolutionary interaction between the regulators and the private

sector, and one of the constants throughout this evolution has been concern for the availability of alternative regulatory structures, with freedom for banks to move from one to another.

A bank that believes it cannot maximize its earnings or otherwise achieve its objectives under one regulatory regimen may try to improve its position by shifting its charter to a different regulator. Examples are the large scale conversion to national charters in the late 19th century after Congress imposed a 10 per cent tax on State bank notes and the subsequent swing back to State charters when the way around this was found in the use of checks rather than currency.

Conversions on a large scale, or by some outstanding institutions, can have a substantial impact upon a regulatory agency. A regulatory agency's standing may shrink along with its administrative authority. In agencies charging fees for supervisory activities a decline in revenues may force the agency to contract its size. The reaction can be what is called "competitive deregulation." This, of course, may take the form either of unwarranted relaxation, or of needed regulatory reform.

The threat of conversion may be a factor making for increased care and fairness in regulatory action. Regulators are never supposed to act in an arbitrary or capricious fashion, but regulators are human, and tend to be more careful if there is a possible penalty for unwise use of their powers than if there is no such possibility.

There are a number of advantages to State bank chartering and regulation. A State supervisor may well be more responsive to local

financing needs and conditions. The existence of two chartering systems, by providing an alternative means of entry into banking, reduces the likelihood that entry barriers will be erected that are unfair or unreasonable. For small bankers, communication as well as responsiveness may be better with a State as opposed to a Federal regulator. This advantage of State regulation is of course less where national regulators have active regional offices.

Further, dual regulation allows competitive forces to work in the banking system despite the heavy governmental role in banking through the chartering authority of the states and the Federal Government and extensive State and Federal supervisory powers.

However, the dual system is not without its costs. Although each State regulatory system may have the advantage of being specialized according to the banking needs of the State, State chartering nevertheless means there are 53 separate regulatory frameworks at the State and Federal levels. To a customer with multiple banking associations this can be a confusing morass, particularly when the regulations conflict. Further, multiple regulators can mean a costly duplication in the development and enforcement of the law. The quality of supervision, especially in the less affluent states, may suffer due to a lack of resources. Certain areas of supervision require highly technical knowledge, which may be difficult for all regulators to obtain. However, in my own estimation, although these faults are not to be taken

lightly -- and partly because I think much can be done to ameliorate them -- they do not outweigh the benefits.

State-Federal cooperation in bank regulation has already avoided substantial costs of overlapping authority, and, I am happy to say, such cooperation is spreading. A few months ago, Chairman Wille of the FDIC announced that his agency would begin a 13-month experimental program, in the States of Iowa, Georgia and Washington, in the cooperative examination of State-chartered nonmember banks. During the period of the experiment, the FDIC will rely heavily on reports of the three State banking departments for information as to the financial condition of half or more of nonmember State banks in each of the three States. The announcement of the experiment said that "the Corporation hopes to discover whether it can adequately exercise its supervisory responsibilities without duplicating the examinations of insured nonmember banks in States with independent and proven examining capabilities."

Early this month, the Indiana Department of Financial Institutions and the Federal Reserve announced an experiment in joint examination affecting member banks. Instead of both the State and the Federal Reserve assigning complete, separate teams of examiners to conduct examinations of State member banks, under the experimental procedure typically a single Federal Reserve examiner will accompany a full team of State examiners. If successful, this, like the FDIC experiment, will result in obvious reductions in cost and in the use of scarce expert manpower, benefiting both the regulators -- at the State

and the Federal levels -- and the commercial banks involved. Even more important, it is hoped that it will result in more effective bank supervision.

I am glad to note that these tests have been welcomed by spokesmen for the Conference of State Bank Supervisors -- which helped plan them -- as implementing ideas the Conference has been putting forth for years, to increase the efficiency of the examination process and to reduce duplication.

Turning now to consideration of bank supervision and regulation at the Federal level, it can be seen that Federal bank regulation has developed into a tripartite system -- the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve System. For over 35 years there have been calls for consolidation of the regulatory activities of these agencies. The 1938 Annual Report of the Federal Reserve System described this state of affairs as

" . . . a crazy quilt of conflicting powers and jurisdictions, of overlapping authorities and gaps in authority, of restrictions making it difficult for banks to serve their communities and make a living, and of conditions making it next to impossible for public authorities to apply adequate restraints at a time and in conditions when this may be in the public interest."

In the early 1960's J. L. Robertson, former Vice Chairman of the Federal Reserve Board, proposed the formation of a Federal Banking

Commission to exercise the present jurisdiction of the three agencies over "charters, branches, mergers, holding companies, fiduciary and foreign banking activities" and disciplinary matters. In addition to suggesting extensive changes in the powers of certain financial institutions, the Hunt Commission recently proposed consolidations of Federal bank regulation. Other groups and commissions have made similar proposals.

Recently, at the request of Chairman McIntyre of the Senate Subcommittee on Financial Institutions, the Federal Reserve Board offered the following statement to the Subcommittee:

"The Board believes that the present arrangement functions reasonably well even though it can result in uneven treatment of banks and is unwieldy because of the need for supervisory coordination. While a more efficient structure might be devised, such as a single regulatory agency, the Board would want to examine carefully the details of any such proposal before expressing a view on the relative merits compared with the status quo. Issues of particular concern would be the qualification of the proposed single agency to regulate objectively, the powers the agency would be granted, and the likely impact of the proposed regulatory restructuring on the Federal Reserve's ability to implement monetary policy."

The central difficulty with fully consolidated Federal bank regulation is a resulting undue and probably overwhelming concentration of regulatory authority at the Federal level. Whatever facsimile of dual State-Federal bank regulation were retained, it would be difficult if not impossible for State regulators to continue to exert any real competitive pressure on the resulting Federal regulatory giant. In my view, this

would be an unfortunate retreat from the cooperative regulatory improvements of recent years.

However, for myself, and, as I see it as regards the Federal Reserve, I find no necessity for the monetary authority to have extensive examining responsibilities as long as certain conditions are met. The Board should have the authority to regulate and supervise bank activities with specific monetary policy implications. Nevertheless, at least at this time, I think authority to regulate bank holding companies should rest where it is, with the Federal Reserve. I think the Board has laid down a solid foundation of basic principles and regulatory guidelines in implementing the 1970 amendments to the Bank Holding Company Act. I believe, and I hope, that this groundwork is sufficiently broad and viable so as to facilitate the transfer, in the future, of this enormous and growing consumer of the Board's time and energies to another authority that, like the Federal Reserve, is sensitive to the needs and responsibilities of all types of banks.

I hope that I have given you a clear idea of where I stand with respect to the chartering and supervision of banks. The duality we have of governmental oversight of banking has evolved, since Revolutionary times, out of long interaction of the public and private sector. We have tried all-out national control of banking, and all-out State control, and have found both wanting. The long process of evolution that has taken place, and the context of freedom of expression and choice in which that evolution has occurred, give me confidence that our bank supervisory and chartering system, as it now stands, can be presumed to be rooted

in reality and to be in all probability a fairly good -- at least -- compromise among the many competing interests involved. Good government is made of such good, if imperfect, compromises. This dualism has preserved, and in late years, enhanced, the tensions of competition out of which better service to the public can flow.

I see in the tensions of the existing system -- public-private, State-Federal, State-versus-State, Federal agency-versus-Federal agency, to say nothing of numerous enclaves wherein various opposed theories of banking and bank regulation can find shelter and sustenance for continued competition -- I see in these institutional and ideological differences the matter from which history's successes have been woven. The alternative to such creative tensions, as I see it, would be domination of banking by some all powerful regulator, or financial disorder the nation could not stand, and would quickly replace with overpowering official control. For all these reasons, and although I see many opportunities for refinement and improvement -- and because I think we are on the road to making those improvements -- I favor continuation of the basic bank regulatory and chartering system we now have.

But, I come now to a type of dualism in banking that I think is both unjustified and harmful -- harmful to banking, harmful to good government and harmful to the public that government and banking serve. That is the dualism of responsibility under which some banks, having chosen not to be members of the Federal Reserve System, are free of substantial costs, in the form of the cash reserves that member banks must hold.

This year, as we have done in previous years, the Board has suggested to the Congress that it enact legislation designed to implement the Board's recommendations for uniform reserve requirements. I am in agreement with my colleagues on the Federal Reserve Board that all banks should share equitably in the responsibilities of reserve holding. This, again, is in the American tradition of pluralism as I understand it. As the glue that binds our many different beliefs, viewpoints, goals, regional differences and backgrounds together, we subscribe to a common set of responsibilities for exercising our competitive freedoms lawfully and fairly. It is when we depart from the rule of common responsibility that we get into trouble nationally, and, in my opinion, it is when banking ignores the desirability of equitable responsibilities that banking invites trouble.

One thing I hope I can accomplish here today -- because I think there has been a great deal of potentially destructive misunderstanding on this point -- is to try to make clear that there is no conflict, as I see it, between the continuance of strong, competing systems of bank chartering and regulation, and universal application of reserve requirements to demand deposits wherever held.

The basic principal underlying the proposed legislation the Board sent to the Congress in January is that equivalent cash reserve requirements should apply to all deposits that effectively serve as part of the public's money balances, regardless of the type of institution in which these balances are held. That is, equivalent reserves should be required

on money subject to check withdrawal and transfer, whether the deposits are in a member bank, a nonmember bank, or in a savings institution where the check used is called a negotiable order of withdrawal.

That is what the proposed change would do.

What it would not do has received less attention, has often been misconstrued, or is often not known at all, so I want to draw this aspect of our proposal to your attention. The draft legislation would:

- Not require any nonmember to become a member of the Federal Reserve System.
- Not require reserves against the first \$2 million of net demand deposits and NOWs at nonmember institutions. This would completely exempt over 3,000 of the small nonmember banks from reserve requirements, and make the impact on slightly larger banks minimal.
- Not require reserves on the time and savings deposits of nonmember institutions.
- Not require nonmembers to start suddenly to hold fully equivalent cash reserves, but would give them a four-year, gradual phase-in period.

There is one other crucial provision of the proposal. This is, that every nonmember institution brought into the uniform reserve requirement system would be able to obtain credit through the Federal Reserve discount window, on the basis of regulations issued by the Board.

Uniform reserves are consistent with dual chartering and supervision of banking. I support both. I think nonmember banks should support both, because nonmember banks will be stronger financial institutions when they have access to the Federal Reserve's discount window. Further, they

will be stronger financial institutions because, in the public eye, they will have adopted a more responsible role.

Most basically of all, I think all deposits available for demand use should be subject to uniform reserve requirements because that is the right, fair and equitable situation. I think everything we know tends to show that where public burdens are to be borne, the American people want them to be borne equitably.

Competitiveness, and all the public benefits that flow from it, is, in my opinion, the heart reason for the preservation and strengthening of the dual system of bank chartering and supervision. Equity is the heart of the uniform reserve proposal. The two go together, in my view, as essential elements of a continued strong banking system in the United States.

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