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Remarks by

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It is a pleasure to appear before the Independent Bankers Association of America Community banks have played—and continue to play — a major role in the economic development of the United States This role is often misunderstood, and all too frequently overlooked This morning, I would like to discuss briefly why I believe that community banks are so important to the economic health of our nation, how regulatory reform would, among other things, affect community banks, and what is needed to enable community banks to maintain their critical role

Virtually from the beginning of our republic, our nation has been blessed with a large number of banking organizations To be sure, our banking system occasionally suffered relatively high rates of failure and losses to note holders, and later depositors But over time the United States evolved a banking system with a structure unlike that of any other country This system is highly competitive and is characterized by a very large number of smaller banks This structure has produced a banking system that is the most innovative, responsive, and flexible in the world

U S banks have had to have those characteristics in order to survive in a market economy subject to rapid change and periodic stress Indeed, our banking system is the envy of the world, not only because of its ability to finance growth and otherwise serve customer needs, but also because of its ability to rebound from crises that may well have devastated more rigid systems The most recent example of our system's resilience is its on-going recovery from the worst banking crisis since the Great Depression After adding over $135 billion to loan loss reserves since 1989, and

after absorbing over $123 billion in net charge–offs since that time, in the last two years U S banks have earned record profits and achieved the highest overall capital position since the early 1960s

Most informed observers recognize the current world class strength of the U S banking system But, what many fail to realize is that the large number of small banks has been an important source of this success, and will remain so Our nation has historically feared financial power almost as much as it has feared political power That is why we went for so long in the 19th and early 20th centuries without a central bank Indeed, the very structure of the Federal Reserve System reflects the desire for diffusion of power and internal checks and balances Our populist roots would, I am sure, simply not have permitted a banking system characterized by a small number of large banks In my judgment, if our system had evolved along those lines, it is quite likely that our banks would have been far more shackled by regulation than today, and it is entirely possible that they would have been, in effect, nationalized We owe much to the small banks that helped us avoid such a result

To be sure, our banking system is going through a period of both consolidation and a continuation of the trend of reduced credit intermediation through banks Nonetheless, both phenomena conceal two important facts First, banks continue to be the backup source of liquidity to those that are increasingly relying on securities markets, as well as being significant — if not the dominant — participants in the foreign exchange and derivatives markets Second, despite the consolidation, our

nation will continue to be characterized by a large number of smaller community banks Consolidation has occurred mainly among our largest banks But, despite the resulting rapid growth at these entities, the smallest U S banks have shown a rapid rate of real asset growth in the last decade or so, indicative of their underlying profitability and their skill at exploiting their market opportunities These are the lenders that know their borrowers and have pioneered so successfully the character loan to entrepreneurs Such credits are the life blood of U S economic growth because it is the smaller businesses, to whom community banks lend, that create so large a share of job opportunities Small businesses do not have access to the capital markets, which cater to larger borrowers Community banks are thus a critical source of credit for small business enterprise

A key, but often overlooked, factor that has encouraged and helped maintain our decentralized banking structure is what we call today the dual banking system This system of both state and federal regulation has characterized our banking structure since the Civil War There were virtually no federal banks until Secretary of the Treasury Salmon P Chase figured out a way to develop a captive market for Treasury debt to finance that war with the creation of national banks And while the 20th century requirement of a national monetary policy, and the adoption of a federal guarantee of bank deposits created the need for federal regulation and supervision of both state and national banks, the great value of having both federal and state bank chartering, rulemaking, and oversight remained This dual banking system fostered innovations that simply could not have occurred as rapidly — if at all — had only federal

regulation existed For example, the NOW account, which has allowed millions of consumers to receive interest on their transaction accounts, and was a major factor leading to the breakdown of national interest rate controls, was invented by a state-chartered bank in Massachusetts Likewise, interstate bank holding company laws, which have been enacted in some form by all the states except Hawaii, and have allowed banks to compete and diversify geographically as never before, originated in a recodification of the Maine banking laws Adjustable rate mortgages are yet another example of innovations pioneered at the state level that have yielded major benefits for both consumers and producers of banking services

In addition to fostering innovation, and perhaps just as important, is the safety valve that the dual banking system has provided for avoiding overly rigid and inflexible federal regulation and supervision The prerequisite for such flexibility is having more than one federal regulator With multiple federal regulators, a bank can choose to change its charter and thereby also choose to be supervised by another federal regulator That potential has placed a significant constraint on the potential for arbitrary and capricious policies at the federal level And, with all federally insured banks subject to federal regulation by some agency, the choice of federal regulator has become a crucial prerequisite for maintaining the dual banking system Indeed, in my judgment, enactment of the FDICIA provision that allows the FDIC to limit the ability of state banks to engage in activities not permitted to national banks has made the choice of federal regulator an even more important requirement for ensuring the health of the dual banking system

Today, a major challenge to the dual banking system has surfaced with various proposals to create one federal bank regulator The clearly stated objectives are to reduce the government's costs of regulating and supervising banks, to reduce bankers' costs and burdens from duplicative examination and overlapping supervision, and in general to make the supervisory process more efficient and more accountable The Federal Reserve Board shares these goals, as I am sure you do However, we at the Federal Reserve simply disagree with the approach of one regulator for achieving these objectives Indeed, it is possible to achieve virtually all of the proposals' objectives without creating the disruptions and risks that so trouble us Virtually all of the cost savings contemplated from a consolidation of bank regulatory agencies could be achieved with two rather than one agency Moreover, if history is any guide, any short–run savings achieved by a monopoly regulator are likely to disappear with time

I would note that reform of the regulatory structure does not address what the Federal Reserve Board and most bankers see as banks' major difficulties — antiquated statutory geographic and product restrictions and the more recent statutorily imposed micro–management of banks' behavior Much of the excess regulatory burden in banking today reflects what I have called elsewhere an overdose of legislative and regulatory reactions to stresses in the banking system that became evident after the mid–1980s As an aftermath, we are left with more examiners and greater complexity in rulemaking than are needed, with the risk of inconsistency in oversight and the reality of persistent demands on management time and energy to satisfy multitudes of examiners These burdens would be reduced only marginally by

reform of the regulatory structure, since the statutorily imposed micro–management of banks would be untouched by reform of the regulatory structure

Nonetheless, there are problems in the regulatory structure that can and should be addressed to reduce burden and to improve government efficiency In evaluating such reforms, the Federal Reserve Board is committed to testing them against four fundamental principles

- First, there should not be a single monolithic federal regulator
- Second, every bank should have a choice of federal regulator
- Third, there should, to the extent feasible, be only one federal regulator per organization
- Fourth, the U S central bank should continue to have its essential hands–on involvement in supervision and regulation

A consolidated single regulator would deprive our regulatory structure of what the Fed considers to be the current invaluable restraint on any one regulator conducting an inflexible, excessively rigid policy The present structure provides banks with a method of shifting their regulator, an effective test that provides a limit on the arbitrary position or excessively rigid posture of any one regulator The pressure of a potential loss of institutions has inhibited excess regulation and acted as a countervailing force to the bias of a regulatory agency to overregulate

The dual banking system and multiple federal regulators have facilitated diversity, inventiveness, and flexibility in our banking system, so important to a market economy subject to rapid change The dual banking system has also provided a safety

valve for inflexible federal positions In an understandable response to some excesses at the state level, especially for thrifts, the Congress in FDICIA called for restrictions on the ability of the states to provide expanded bank and thrift activities But a single federal regulator would—especially with that FDICIA provision—effectively end the dual banking system it would become an empty shell if a state–chartered entity had no choice of federal regulator or different asset powers The dual banking system cannot survive consolidation at the federal level I, as well as my colleagues on the Board, believe that would be a tragic loss

In addition to the option a bank now has to change its regulator by changing charter or Federal Reserve membership status, another equally important check and balance would be lost if the current regulatory structure were replaced by a single regulator Through the Federal Financial Institutions Examinations Council, the agencies endeavor to adopt consistent rules and regulations That process of sharing points of view and expertise has demonstrably improved the final product, tending to eliminate the extreme and unworkable positions, and assuring that the Fed's concerns about systemic and economic problems are considered A single consolidated regulator would not benefit from this process and might well tend to be less receptive to modifications of a preliminary, and even more so of an adopted final rule In short, there is a kind of a built–in arbitrariness that comes with a single regulator

Moreover, a regulator that does not have macroeconomic responsibility for its actions is likely to inhibit prudent risk–taking by banks, thus limiting economic

growth and stability The historic purpose of banking, as community banks know so well, is to take risks through the extension of loans to businesses and others. Economic growth in our system could not occur without risk–taking by entrepreneurs and small and large businesses Risk–taking requires financing Thus, either an unwillingness or an inability of lenders to take risks will slow the expansion of our nation's employment and income This fact creates a significant conflict in banking regulation, especially because of the government guarantee of bank deposits On the one hand, regulators are concerned about bank failures and their effects on the economy, as well as their cost to the insurance fund On the other hand, banks need to take risks to finance growth Tradeoffs are required, and a zero bank failure rate implies that banks are not meeting their key economic function We have recently seen how banks' reduction in their willingness to take risks as a result of FDICIA, new regulations, weakened capital, and large loan write-offs, contributed to a credit crunch and slower economic growth Tradeoffs are tricky and a swing in either direction can create both short– and long–term problems

Indeed, a single regulator with a narrow view of safety and soundness and with no responsibility for the macroeconomic implications of its decisions would inevitably have a long–term bias against risk–taking It receives no plaudits for contributing to economic growth through facilitating prudent risk–taking, but it is severely criticized for too many bank failures The incentives are clear Such an agency would have little inclination for trade–offs

The Fed's economic responsibilities are an important reason for its consistent supervisory policy Our stabilization objectives cause us to seek to avoid either excessive tightness or ease in supervisory posture The former leads inevitably to credit crunches, and the latter to credit policies that contribute, with a lag, to bank losses and failures This is not to say, as some have advocated, that the Fed itself should be the only regulator A single regulator Fed would be just as prone to arbitrary and capricious behavior as any other single bank regulator We would thus oppose such an initiative

Not only it is important that one of our regulators have macroeconomic responsibility in order to carry out the regulatory function properly, but also our central bank must continue to have hands–on involvement in supervision and regulation in order effectively to carry out its macroeconomic responsibilities Joint responsibilities make for better supervisory and monetary policy than would result from either a supervisor divorced from economic responsibilities or a macroeconomic policymaker with no practical experience in the review of individual bank's operations Without the hands–on experience of regulation and supervision, and the exposure to the operations of banks and markets provided by such experience, the Federal Reserve's essential knowledge base would atrophy Its deliberations would become increasingly academic and the nation's central bank would soon resemble an ivory tower rather than an institution necessarily involved with the day–to–day activities of our economic and financial system

Removing the Federal Reserve from supervision and regulation would greatly reduce our ability to forestall financial crises and to manage a crisis once it occurs In a crisis, the Fed, to be sure, could always flood the market with liquidity through open market operations and discount window loans But while rapid liquidity creation is often a necessary response to a crisis, supervision and regulation responsibilities give the Fed insight and the authority to use less blunt and more precisely calibrated techniques to manage such crises and, more importantly, to avoid them The use of such techniques requires both the clout that comes with supervision and regulation *and* the understanding of the linkages among supervision and regulation, prudential standards, risk taking, relationships among banks and other financial market participants, and macroeconomic stability

The Fed plays the key role when systemic breakdown threatens Such episodes invariably create fear and uncertainty among participants in the financial markets Fear of counterparty risk escalates, and the threat of paralysis in financial markets and the breakdown of payment and credit arrangements that underpin them become all too real It is important that a regulatory authority fully familiar with the dynamic international economic and financial forces in play be available to counsel and urge rational responses—and, as a last resort, provide liquidity If regulatory authority is vested in a single agency and little in the central bank, our nation's ability to forestall or to respond efficiently and effectively to a crisis would surely be impaired

There are other ways, short of the creation of a single agency, to address the problems in the current regulatory structure The crux of the issue is duplicative examinations of banks and regulatory overlap for a given multibank holding company organization, where no one regulator has full authority for the entire banking organization This problem could be eliminated by a regulatory system that maintained two federal regulators, but provided that in general only *one* of those regulators supervised *each* banking organization from top to bottom Undoubtedly there are several approaches that preserve choice and retain a major role for the central bank But whatever the approach, our dual banking system and a central bank with a significant role in bank supervision are too important to sacrifice in anticipation of benefits which can be obtained in less risky ways

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