For release on delivery
9 45 a m PDT (12 45 p m EDT)
April 16, 1994

Remarks by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

at the

Annual Meeting and Conference

of the

Conference of State Bank Supervisors

San Francisco, California

April 16, 1994

I am delighted to join you at the beginning of your annual conference Recent proposals and discussions about our regulatory structure have required me to think more about the nature of state bank regulation and its importance to our economy I have reviewed and re–read a good deal of banking history, and have taken a closer look at the statistics I have come away from all of this with a renewed sense of the importance of our dual banking system

The U S economy has many characteristics that have contributed significantly to its growth and to the widespread diffusion of its product among American citizens These include a vast area and highly productive population, unparalleled natural resources, limited government regulation, a reliance on markets and entrepreneurial innovations, and — critically, I would argue — a flexible and dynamic financial system That system could neither have developed to its present state nor could it be long maintained without the very responsive and creative banking system that underlies it

I am often bemused when both foreign and American observers compare the U S and foreign banking structures, note the uniqueness of the American system, and conclude that since it is so different it should be changed These critics seem unwilling to consider the possibility that these very differences are an important reason for the dynamism of the U S economy that has given us such a high standard of living That is is not to say that our banking system has no blemishes, that it needs no reform, or that technology and market forces will leave it unchanged in the future But to change our bank structure just to make it look like that of other countries, or solely to make regulators marginally more efficient, seems misplaced at best and likely harmful to our economy

Our banking system is, in fact, 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 Recall just a few years ago the bank failure rates, the losses, the deteriorating asset quality, the capital depletion, and the unwillingness to extend credit But since late 1989, U S banks have diverted over $109 billion from earnings to loan loss reserves, absorbed $106 billion of charge–offs against those reserves, raised over $46 billion of new equity capital, and in the last two years earned record profits, reaching the highest overall capital position since the early 1960s and have become willing lenders once again That is just one more remarkable record, this one so soon after the worst banking crisis since the Great Depression

Our banking system is distinguished by two structural hallmarks the very large number of entities and the division of the supervision and regulation of banks between the states and the federal government To be sure, the advent of federal deposit insurance has meant that all banks have some federal oversight But, the dual banking system has nevertheless remained strong and healthy Indeed, the state regulated sector — long felt to be an historical artifact — continues not only to survive but to increase its relative position

With only minor exceptions, the banks in the early years of our republic were state chartered and state regulated From the very beginning, there was significant congressional distrust of banks with their little understood, and to many fearful observers, fraudulent ability to create money by issuing notes in excess of their specie reserve Banks at that time financed their assets mainly by issuing their own circulating promissory notes rather than taking deposits, and there was such a shortage of "money" to finance trade that the sheer economic need for those notes overcame the

fears of banking in the minds of federal legislators There was considerably less fear in the state legislatures, which, as now, were closer to the needs of local trade Indeed, by the very early 19th century the number of state banks began to show a significant increase

Through those early years, each bank received its specific charter directly from the legislature, a cumbersome, time–consuming, and politically charged procedure Many of these banks were, in fact, chartered to finance a specific project—like a railroad, a canal, or a bridge And, as you might suspect, given the now well–known problems of loan concentration, their failure rate was high With the closing of the Second Bank of the United States in 1836 — a federal bank that, among other things, tried to keep the state banks from issuing excess notes by gathering them up and presenting them for specie payment — states began to look for ways not only to more easily establish banks (and put more money into circulation) but also to have a safer system In the process, the states created their first real banking innovation the so–called free banking laws—first proposed in New York and first enacted in Michigan in 1837

Under free banking laws, no special legislative charter was required Rather, anyone could apply for and receive a bank charter so long as a certain minimum capital was raised and certain assets (usually, but not always, state bonds) pledged dollar–for–dollar behind the bank's note issuance The virtual automaticity produced the "free" part of the title The collateral and capital rules added "safety" As soon as the first note could not be redeemed, the state would close the bank, redeem the notes with the pledged assets and, if necessary, the bank's capital By 1860, 18 of the 33 states had free banking and 3 more had bond–secured note issues

Many historical writers have not treated free banking well Often it was called "wildcat" banking because of the charge that, in fact, unscrupulous bankers placed these banks in distant locations —"where only wildcats go" — issued notes, and left with the assets when noteholders, who finally arrived at these distant locations, sought redemption By implication, if not explicitly, poor state regulation was charged

More recent research suggests that free banking worked far better than the older textbooks indicated Once the note collateral rules were modified to value collateral at market value rather than at par and the permissible collateral options were narrowed, losses to noteholders of free banks became modest Moreover, the vast proportion of bank failures reflected not fraud, but sharp drops in prices of state bonds that made up a large part of bank portfolios When such failures — whose initiating causes were outside the banking system and beyond its control — occurred, they were generally not followed by runs

The state innovation of collateralized notes and minimum capital requirements was copied in total by the framers of the National Bank Act of 1863 National banks were not created solely in order to develop a common U S currency, although the costs and inefficiencies of tracking values of the myriad of state bank notes were no small problems Rather, Secretary of the Treasury Salmon P Chase was intrigued with the possibilities of a captive market for treasury debt that would result from a requirement that the collateral behind national bank notes be treasury securities In addition, because of a tax on state notes, national banks would be the only set of banks free to issue notes In short, the pressures of Civil War finance melded nicely with the application of a banking principle developed by the states Note collateral and capital requirements became the hallmark of the new national banks

While state banks were taxed out of the note–issuing business by the National Bank Act, deposits — which had always been among U S bank liabilities — had already grown to exceed notes by the mid–19th century Indeed, it might be argued that the National Bank Act did the state banks a favor by forcing them to focus on the growth area of banking deposits and payments by checks As one might readily anticipate, the number of state banks initially declined sharply after 1863 as banks changed charters to continue their note–issuing capability Indeed, five years after the act was passed, there were only 250 state banks compared with over 1,600 national banks But by the last decade of the 19th century, the number of state banks had grown to exceed the number of national banks, a structure that has continued without exception to this day

The increase in the number of U S banks — both national and state — in the late 19th and early 20th Centuries was truly phenomenal, reaching a peak of over 30,000 in the early 1920s As I noted earlier, the large number of individual banks is one of the special characteristics of U S banking — so special that no other G–10 country has anywhere near the number of commercial banks per capita of the U S

The large number of individual U S banks has helped to create a highly competitive system, characterized by a large number of smaller banks In my judgment, this structure has been critical in producing 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

But it is not just these characteristics that have been so important It is often overlooked that the large number of small banks in the U S banking structure has

also played an important political and cultural role in the success of the U S economy Our nation has historically feared the concentration of financial power That is why we went for so long in the 19th and 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 If our system had evolved along those lines, it is quite possible that our banks would have been far more shackled by regulation than today We owe much to the small banks that helped us avoid such a result

To be sure, a consolidation trend is currently underway in U S banking This trend, I suspect, will be accelerated by the shift from partial interstate *banking*, authorized now in all but one state, to interstate *branching*, which apparently has a very good chance of soon being authorized nationwide by the Congress Some observers believe that this trend will spell the end both for small banks in the U S and for the dual banking system I do not In all likelihood, there are going to be thousands of banks in the U S for as long a period as I can foresee, and I believe that most of the smaller ones will choose to be state chartered

This judgment rests in part on the fact that extensive research over the years suggests that economies of scale are quite limited in banking Aside from efficiency associated with size, recent research indicates that in each size class of banks there is wide variation in cost structures, variation that simply overwhelms any economies of scale Some banks in each size class are just better than others in that size class at cost control, risk management, marketing, and other aspects of managerial expertise Moreover, there seems to be little evidence that a well-managed, large, efficient acquirer can transfer that advantage to an acquired firm,

at least in the early years of a merger In addition, the evidence continues to confirm that large banks entering a new market by acquisition are usually not able to expand the market share of the acquired firm, and often lose market share to *de novo* local banks Indeed, successful new entry into markets with existing large banks (provided the local economy is strong) is a characteristic of U S banking that has not changed over the years, nor do I expect that it will

In fact, entry into the banking industry has become easier over time In the not–too–distant past, in order to obtain a new bank charter, one had to demonstrate that the banks in the market were not meeting the needs of the market, that the new bank would be profitable within a certain time period, and that the new bank would not harm the existing banks Frequently, as you might expect, the existing banks protested the application for the new bank and were able to block entry Now, most of those requirements are gone.

All of this is not to deny that there is a definite and growing market need for large banks offering sophisticated services to a national and international market And technology will, I think, continue to expand the efficient scale at which all organizations, especially financial firms, can operate But most businesses and households do not need the types of services that only large banks can provide The basic bank product lines, as well as those evolving — mutual funds, security brokerage, and, yes, even insurance sales — smaller banks do and can offer Plus, small banks can add to the product mix what larger banks often cannot personalized service, local market knowledge, and easy access to the officers of the bank Nonetheless, the smaller banks of the future, I suspect, will choose to adopt many of the innovations now being developed by large banks, just as large banks have learned by their own

experiences not to lose the focus on the customer that small banks have long understood

For these reasons I believe that the U S banking system, despite consolidation and interstate banking and branching, will continue to have a large number of small banks in profitable competition with a group of regional banks and a much smaller number of very large banks I suspect that there will never be very many truly nationwide banking organizations Despite the fact that interstate banking began to evolve nearly twenty years ago, today there are only six banking organizations operating in ten or more states, and two of these had a headstart in multistate operations that were grandfathered by the Bank Holding Company Act of 1956

What does a structure of a reduced number of banks — albeit still an unusually large number by international standards — imply for our dual banking system? The answer depends in large part on the states Most of the banks will still be small and operating intrastate in local markets And, by the record, most of these banks have opted for a state charter I see no reason for that to change But the regional and truly national banks may find that state charters create a burden if they are forced to operate under different regulatory rules and procedures in multiple states At some stage that burden is likely to exceed the other benefits of the state charter — especially if the FDICIA provision to limit state–adopted new activities at insured banks is employed extensively If that burden becomes excessive, banks with interstate operations — especially those with interstate branch operations — will, I think, turn to the national charter in order to eliminate multiple and conflicting rules

It is thus in the interest of the states and the dual banking system to develop regulatory procedures that meet the needs of the states but recognize the new

reality of interstate banking — especially interstate branch banking For example, consideration ought to be given to interstate compacts in which the host state examiner acts as agent for the home state in the examination of branches located in the host state, and all examiners apply a uniform set of supervisory principles that govern examination standards and supervisory policies, such as loan classifications and lending limits States that pioneered regional compacts during the early years of interstate banking will know exactly what is required The states and the CSBS might even develop a suggested uniform code for addressing common examination and supervisory issues. If the problem is not addressed, the dual banking system will, I fear, have a state sector that is almost totally made up of small intrastate banks It would, I think, be a loss if larger banks did not have a real option to obtain a state charter

The benefits of dual banking are significant, in part because the states have fostered innovations that simply could not have occurred as rapidly — if at all — had only federal regulation existed I have already noted that the free banking approach was the model for the National Bank Act More recently, the NOW account, which has allowed millions of consumers to receive interest on their transaction accounts, and was a major factor leading to the fortunate disappearance of national interest rate controls, was invented by a state-chartered savings bank in Massachusetts Likewise, as I noted, interstate bank holding company laws, which have been enacted in some form by all the states except Hawaii, and have allowed bank holding companies to compete and diversify geographically as never before, originated in a rewriting 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

As you know, the Federal Reserve consistently has been a strong supporter of the dual banking system For some time we — as well as the FDIC — have sought an examination process partnership with the state regulators Currently the Fed has cooperative agreements with 37 states, calling for either joint or alternate year exams Our experience has been quite positive in these programs, and more importantly, the state banks have benefited from the dual approach.

One of the reasons that we participate in the cooperative arrangements is the quality of the state supervision we find in the accredited states Based on failure rates, the evidence suggests that state banks compare favorably with national banks, apparently benefiting from having both state and federal supervision. For example, from 1986 through 1992, almost surely the most traumatic period in U S banking since the Great Depression, the national bank failure rate was considerably greater than state banks While failure rates alone are not a sufficient measure of supervisory success, these data do speak well of state supervision

In sum, our dual banking system, with its large number of banks, has played a significant role in the political and economic development of our nation State banking is alive, vibrant, innovative, and expanding The Federal Reserve supports the dual banking system because of its past, current, and future contributions With the real possibility that interstate branching will be enacted this year, the states will have to address modifying examination procedures and regulations so as to protect their interests while accommodating state banks operating branch systems over wider

regions than a single state As adjustments are made to reflect the evolving environment, I have no doubt that state banking will continue to play a significant and important role in the local, state, regional, and national economies

* * * * * * *