THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

March 8, 1978

MEMORANDUM FOR THE PRESIDENT

From: Stu Eizenstat
Charlie Schultze CLS

Subject: Consolidation of Commercial Bank Regulatory Functions into a Single Federal Banking Commission

The idea of consolidating bank regulatory functions into a single Federal Banking Commission has the strong endorsement of Senator Proxmire and the staff of the Senate Banking Committee (although probably not a majority of the Committee members) and the basic idea (not the details of Senator Proxmire's specific proposal) has also been endorsed in a report by the Senate Committee on Governmental Affairs.

Under current law, commercial banks can be chartered either nationally or by states. National banks are regulated in most respects by the Comptroller of the Currency and must be members of the Federal Reserve System. State banks may be members of the Federal Reserve System, in which case the major Federal regulatory oversight is in the Fed. State nonmember banks that are insured are regulated at the Federal level by the FDIC.

This crazy-quilt pattern grew up through historical accident. It has been cited by some as an example of the need for reorganization and consolidation in the Federal Government. It has undoubtedly entailed some measure of inefficiency in the regulatory process and may have occasioned undesirable practices in markets served by commercial banks. Nevertheless, it has functioned since the great depression to avert the kind of cumulative financial crises that threaten overall economic stability.

Whether bank regulation would have been superior if it had been lodged in a single agency is debatable. If a single Federal regulatory agency were to become "captive" of the banking industry or some particular part of it, the end result could be worse than the results of the existing system. On the other hand, some pressures in the direction of looser regulation or opportunities for banks to evade restrictions might be avoided.

The basic arguments for consolidating the regulatory function into a single commission are (a) that there is inefficient overlapping of regulatory jurisdiction and, at the same time, the possibility for activities needing regulation to "slip between the cracks," and (b) that banks can choose their regulator, while the regulators can compete for clientele by accommodative regulation. Moreover, during the first half of the 1970s a number of questions arose about the safety and soundness of the commercial banking system.

1) Are banks adequately capitalized to protect their operations in event of losses?

2) Are banks making sound judgments about the risks entailed in a rapidly growing volume of foreign lending?

3) Is regulatory vigilance adequate to protect the soundness of banks against insider abuses, inappropriate takeovers, involvement in excessively speculative real estate transactions (some of them prompted by tax-preference provisions of the tax code which were partially corrected in 1976 legislation and which your tax proposals will further ameliorate?

4) Are merger and holding company regulations being administered so as to prevent anti-competitive developments?

Supporters of consolidation allege that a single Federal bank regulatory agency is needed to deal more adequately with these problems.

The question arises as to what the Administration's priorities should be in regard to financial regulatory issues. Several considerations are relevant:

- The problems of safety and soundness of the banking industry are not as critical as they were several years ago. Problems have been shaken out, banks have come to recognize and reduce certain risks, the regulatory environment seems to have become more vigilant, and the regulators are becoming better informed concerning both real estate and foreign lending. A serious domestic or international financial crisis would cause problems for some banks but we have no reason to believe this implies fundamental unsoundness in the banking system, or that the problems would necessarily be eased by having s single bank regulatory agency.

- Steps -- such as S. 71, a bill to increase certain powers of the regulators that was introduced by Senator Proxmire in January 1977 and passed the Senate last August -- can be taken within the current organizational framework.

- The functioning of financial markets is changing. New institutions and practices are evolving (for example, the growing role of credit unions and electronic funds transfer mechanisms) and it is important to consider what regulatory issues are posed by these developments.

- There are substantive issues pertaining to financial regulation which are under consideration by the regulators or within the Administration which address some significant current issues. (For example, the Federal Reserve is now reviewing issues relating to bank holding companies and there is an interagency task force studying the question of interest rate ceilings.)

Although these considerations reduce the immediate pressure for reorganization of the banking regulatory agencies, we can expect a continuing interest in our position on the need for such a reorganization. It is therefore important to recognize that a major reorganization effort would entail serious difficulties:

- o Separation of regulatory powers from the monetary policy powers of the Federal Reserve would require very careful design. Chairman Miller should certainly be given time to assess this issue. Reduction of the Federal Reserve's regulatory powers has been strongly resisted by the Federal Reserve in the past.

- o The regulatory agencies are clearly jealous of their powers and also have constituencies. Hence, the political problems would be very substantial. Very significant opposition would arise from some banking groups, most state banking supervisors, and Congressmen with connections to the banking industry.

- o Steps toward regulatory consolidation would very likely be accompanied in the Congress by an increase in detailed regulation that substitutes for market competition -- exactly the opposite direction from the thrust of your other regulatory reform initiatives.

For these reasons, we do not believe the Administration should at this time propose or support a major reorganization of bank regulatory agencies. But there are improvements that we can make. An informal coordinating committee now exists among the regulators to deal with the setting of interest rate ceilings and, from time to time, this or other ad hoc committees have considered and attempted to coordinate regulatory policies in other areas. The establishment by law of a Financial Institutions Examination Council has recently been proposed in the House and a similar bill is pending in the Senate. This Council would promote uniformity of bank examination procedures and standards. It could be the forum within which regulatory policies to protect the safety and soundness of financial institutions would be reviewed and developed as necessary. This is a very desirable step which the Administration has endorsed. The existence of a Financial Institutions Examination Council may be able to solve those legitimate problems that result from "lowest-common-denominator" regulation. Its establishment is a logical next step in an incremental improvement of financial regulation.

We have discussed the contents of this memo with Treasury and OMB, and both agencies are in general agreement with our appraisal. We all recommend that the Administration continue vigorously to support legislation to establish a Council.

The issue is whether we should initiate a formal "study" of the banking consolidation issue at this time. CEA, Treasury and OMB oppose such a study, and believe that support for the Examination Council would be a positive response to Senator Proxmire's proposal and would indicate our concern with overlapping functions and regulations. In pressing for legislation to establish the Council, it can be emphasized that the Administration considers your transportation reform initiative and your Executive Order on Improving Government Regulations also to be high priority efforts in regulatory reform for 1978. At the same time, however, Senator Proxmire can be assured that questions of financial regulation would be reviewed carefully as we develop our regulatory reform and reorganization priorities for 1979.

Stu's view is that the consolidation question raises legitimate substantive issues and that there is substantial pressure from Senator Proxmire at least to "study" his allegation that the present regulatory structure has created inefficiencies and weakened the banking system. Stu has no opposition to such a study but in view of the reluctance of the three relevant agencies to initiate this study, Stu would concur with the recommendation of CEA, OMB and Treasury that no study be undertaken at this time.

___✓___ Approve (Inter-agency recommendation) ok - "at this time" J

_______ Disapprove

_______ Give me more information