A STUDY OF PROBLEMS AND ALTERNATIVES IN THE FEDERAL SYSTEM OF BANK SUPERVISION

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TO MY PARENTS, THANK YOU.

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CHAPTER I

INTRODUCTION

Statement of the problem. The present federal system of bank supervision, consisting of three agencies--the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System, and the Comptroller of the Currency--has built-in conflicts and inefficiencies that have drawn a great deal of criticism over the years.

The criticism has come from a variety of sources, including newspapers, periodicals, banking authorities, members of Congress and even the President. All have advocated some form of change in federal bank supervision.

The purpose of this paper is to examine the criticisms, discuss proposed improvements and decide what, if any, changes should be made.

Six chapters form the body of the report. The first of these, Chapter II, gives some pertinent historical background, which includes the origin of the three agencies, the conflicts that have resulted, and some of the more prominent critics down through the years.

Chapter III describes the system today and how the agencies handled their structural conflicts. The next chapter lists the major problems that critics believe still hamper the system.

Various proposals have been offered through the years as improvements of federal bank supervision; these are discussed in Chapter V. In contrast, Chapter VI is a look at the position of those satisfied with today's supervisory arrangement.

The last chapter is an attempt to unite the preceding chapters into a conclusion as to what should be done with the present regulatory set-up.

Research for this study was conducted predominantly in the main library of the Kansas City, Missouri, Public Library system and in the Research Library of the Federal Reserve Bank of Kansas City.

Using the facilities of these two locations much of the material was found in issues of Banking, the Wall Street Journal, various Federal Reserve System publications, and the government documents from the 1965 Hearings of the U.S. House of Representatives Banking and Currency subcommittee.

Most of the information used in the paper has to do with developments since the creation of the Federal Deposit Insurance Corporation in 1933.

CHAPTER II

HISTORICAL BACKGROUND

Commercial banks have had a role in the development of the United States from the beginning. The Bank of North America was performing valuable services for both the government and the general public before the country's Constitution was adopted.

Lacking the power to tax, the central government looked to the Bank of North America for large loans. In addition, the Bank was issuing good quality notes that could be redeemed in specie on demand.[1]

Today, the banking system provides the principal means of payment in the conduct of business and private transactions, as it has for decades.

To perform this function effectively requires the confidence of the public; a confidence that has not always been easily maintained. For example, preceding the Civil War many banks abused their power to issue notes.

> In 1859, a well-known service listed 5,400 different types of spurious notes. Merchants often had long lists posted in front of their shops to indicate the discounted value of different bank notes. Mark Twain tells of a traveler, who supposedly was thrown off a train

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[1] Eli Shapiro, Ezra Soloman, William White, Money and Banking (New York: Holt, Rinehart and Winston, Inc., 1968), p. 157.

> by the conductor, because none of the great quantity of paper currency the traveler had was acceptable in paying for the price of a train ticket. Such a depreciated paper money system was sometimes almost as inconvenient as the barter system.[2]

ORIGIN OF FEDERAL BANKING SUPERVISION

Partly because of this chaotic banking system an important reform measure, called the National Banking Act, was enacted during the Civil War.[3] Among other things, it provided for some banking supervision by establishing the office of the Comptroller of the Currency in the U.S. Treasury, and it set up a system of required reserves.

The required reserves provision was a valuable addition to the nation's banking operations. However, it had some faults and these contributed to a series of financial panics in 1873, 1884, 1893, and 1907.[4]

For example, country banks were allowed to keep part of their legal reserves in New York City banks resulting in a pyramiding of bank reserves. "The reserves were pyramided because they were counted twice as cash, both by the country bank and the New York City bank."[5] The effect was to accentuate the seasonal credit pressures on the New York City banks, contributing to the series of financial panics.[6]

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[2] John H. Cochran, _Money, Banking and the Economy_ (New York: MacMillan Company, 1967), p. 62.

[3] _Ibid._ [4] _Ibid._, p. 64. [5] _Ibid._, p. 64.

[6] _Ibid._, p. 64.

The 1907 panic provided the resolve in the nation's lawmakers to correct the faults of the National Banking Act and to make other improvements, such as the creation of a central bank. The result was the formation of the Federal Reserve System.[7]

However, even with the steadying influence of the Federal Reserve, the country's banking system was far from perfect, as was evidenced when it collapsed in 1933.

The collapse lead to other improvements, one of which was the introduction of a nation-wide deposit insurance program under the direction of the third federal banking agency, the Federal Deposit Insurance Corporation.

Together, the three government bank regulators contribute to a banking system that is much more capable of providing the needed public confidence and services than was the system of 100 or 200 years ago. Even so, as the remainder of this paper indicates, there is still room for improvement in federal banking regulation.

AGENCIES FORMED OUT OF NEED

As described in the previous section, each of the three federal agencies involved in regulating the banking industry was created to alleviate a specific problem of its

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[7] Ibid., p. 65.

time. Thus, creation of the Comptroller of the Currency was an attempt to establish order out of the banking chaos that preceded it.

The Federal Reserve System was born in response to the depression, panic and bank failures that arose during the first decade of the twentieth century.

And finally, the Federal Deposit Insurance Corporation, formed just after the great depression of 1929, was to prevent deposit losses that contributed to and aggravated that depression.

"As a consequence, the development of the mechanism of supervision has been piecemeal in character and not in accordance with comprehensive plans made with reference to the country's banking needs taken as a whole. From this process the banking picture emerges as a crazy quilt of conflicting powers and jurisdictions, of overlapping authorities and gaps in authority."[8]

JURISDICTIONAL CONFUSION

A brief look at the current regulatory situation is sufficient to see the truth in the above paragraph, since nearly all banks are under the control of at least two and

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[8] Federal Reserve Annual Report, 1938 (Washington: Board of Governors of the Federal Reserve System, 1938), p. 3.

often three of the regulatory agencies.

An exception are the uninsured state banks; they are subject to only the state examiner. However, these are relatively insignificant because they comprise less than four per cent of the nation's 14,000 commercial banks.[9]

The insured state banks are subject to the state supervisory agency, plus the Federal Deposit Insurance Corporation. If an insured state bank becomes a member of the Federal Reserve System, and many have, the bank reaches the position of being regulated by three different agencies.

The same thing applies to nationally chartered banks to a greater extent, because these must be insured and must be members of the Federal System. Hence, like their state counterparts, national banks are under the jurisdiction of three bank regulatory agencies--the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation.[10]

The jurisdictional complications evident in the overlapping legislation are really more complex than is immediately apparent, because the legislation also gives the

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[9] A Career in Bank Supervision, Federal Deposit Insurance Corporation (Washington, D.C.: 550 17th St. N.W.), p. 1.

[10] United States House of Representatives, Consolidation of Bank Examining and Supervisory Functions, Vol. Y5B22/89.1C73H (Washington: Government Printing Office, 1965), p. 79.

various agencies the responsibility of issuing supplementary formal regulations.[11]

These regulations are meant to clarify the application of the laws to specific controversies, which seemingly would help relieve some of the confusion resulting from the overlapping. However, when the overlapping agencies issue formal regulations independently of each other the dilemma is not relieved, but aggravated.

A good illustration of the difficulties created by such extensive overlapping was given in a speech made by Glenn M. Goodman in 1953. At that time he was an assistant director of the Federal Reserve's examiners division. He stated:

> Our banking system is characterized by a mass of banking legislation. The legislation, moreover, is supplemented by formal regulations issued by various agencies under responsibilities delegated by law. In some cases one supervisory agency issues regulations affecting banks under the immediate supervision of other agencies.
>
> Thus the Comptroller of the Currency issues a regulation regarding the purchase of investment securities to which state member banks are subject as well as national banks. So far as the State member banks are concerned, administration and enforcement of the regulation rest with the Federal Reserve authorities rather than with the Comptroller of the Currency.

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[11] Glenn M. Goodman, "Bank Supervision in the United States," Lectures Before the Center for Latin American Monetary Studies (Washington: Board of Governors of the Federal Reserve System, 1953), p. 11.

> On the other hand, the Board of Governors issues a regulation that pertains to the trust operations of national banks but enforcement rests with the Comptroller of the Currency. The Federal Deposit Insurance Corporation has regulations that are applicable only to insured nonmember banks and others that are applicable to all insured banks.[12]

So an unfortunate situation, though not unlikely, might find one of the federal regulatory agencies issuing a formal regulation and depending primarily on one of the other agencies for enforcement.

CALLS FOR REFORM

Since the establishment of the Federal Deposit Insurance Corporation in 1935, there have been numerous calls for change in banking supervision at the federal level.

One of the earliest critics of the "three-headed supervisor" was William Smathers, U.S. Senator from Pennsylvania. In April, 1938, Senator Smathers introduced bill 3877 into Congress with the declared intent "to provide for a more effective and economical administration of the laws relating to banking institutions; to provide a self-sustaining agency of the Federal Government, independent of any conflicting interest, to examine and supervise banking institutions."[13] It wasn't enacted.

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[12] Ibid.

[13] William Smathers, "Bill 3877," Congressional Record, Vol. 83 (Washington: Government Printing Office, 1938), p. 439.

About that same time, two different organizations were analyzing the need for altering the bank supervisory system. One, the Brookings Institute, a non-profit corporation devoted to serving the public through economic and governmental research, conducted a study at the request of Congress.[14]

The other treatment appeared in the 1938 annual report of the Board of Governors of the Federal Reserve System. Among other things, both Brookings and the Fed mentioned the implicative idea that the present structure of Federal bank supervision is an historical accident rather than the result of a broad approach to what is needed. In addition, both made suggestions that are treated later in the paper.

In 1949, another group, this one commissioned by President Truman and presided over by former President Herbert Hoover, investigated the need for re-organizing the federal government. The Hoover Commission, as it was called, from its comprehensive study of the government found many areas in need of structural and functional change. One area, federal supervision of the banking industry, was believed to be in need of revamping because its structure created some problems for the industry: such as, "the annoyance and

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[14]"The Brookings Institution," Encyclopedia Americana (1958 ed.), IV, 591.

confusion of multiple control."[15]

CONGRESSIONAL HEARINGS SPARK INTEREST

The greatest Congressional publicity the bank supervision controversy has received was in 1965 when Rep. Multer of New York conducted sub-committee hearings for Rep. Wright Patman's House Banking and Currency committee.

Some of the material in these hearings was based on the 1963 hearings of a similar House sub-committee.

The attention brought to the subject helped encourage a few publications to offer an opinion. The *Washington Post* was of the opinion that the moral to be drawn from the investigation of banking irregularities is "that the bank examination and supervising functions, now lodged in three independent agencies of the Federal Government, should be consolidated."[16]

The *Wall Street Journal* in separate, but related editorials, criticzed the three-tiered bank supervisory arrangement. In the first editorial, the paper concluded that the arrangement is ridiculous and dangerous, especially

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[15] George E. Lent, "The Changing Structure of Commercial Banking," *Tuck Bulletin No. 24* (Hanover, New Hampshire: Dartmouth College, The Amos Tuck School of Business Administration, 1960), p. 7.

[16] Editorial in the *Wall Street Journal*, April 21, 1965.

in an area as important as banking.[17] The other one pinpointed the source of the trouble as "that system, under which the Comptroller, the FDIC and the Federal Reserve share federal regulation of banking, with responsibilities that frequently overlap."[18]

Opinions such as those expressed by the _Wall Street Journal_ and the _Washington Post_ are not foreign to the academic field, either. The authors of a recent college textbook summarized their views as follows:

> The current status of supervision, nevertheless, leaves much to be desired. Overlapping jurisdictions create many problems . . . Consolidation of supervisory agencies would simplify the problem and reduce expense by eliminating duplication.[19]

PRESIDENTIAL CONCERN

The most prominent attention the bank supervision controversy has attained recently was in 1964, when Douglas Dillon, then Secretary of the Treasury, received the following letter:[20]

Dear Mr. Secretary:

I am concerned about reports of a lack of coordination

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[17]_Ibid._, February 23, 1966.

[18]Editorial in the _Washington Post_, April 11, 1965.

[19]Shapiro, Solomon, White, _op. cit._, p. 193.

[20]United States House of Representatives, _loc. cit._

> of action and procedures among the Federal agencies charged with the responsibility for the regulation of banks.
>
> I am sure that when two or three agencies have overlapping or coordinate statutory responsibilities, as is the case in the area of bank regulation, there will be differences of opinion. . . . Nevertheless, from a standpoint of overall public policy, it is important that they follow orderly procedures and that all agencies work together to try to accomodate the views of the others.
>
> I am directing you, as the chief financial officer of this administration, to establish procedures which will insure that every effort is made by these agencies to act in concert and compose their differences.
>
> Sincerely, Lyndon B. Johnson

The action taken by Mr. Dillon at the President's request is discussed later in the paper.

Some of the sharpest criticism of banking regulation has come from within the industry. For example, James L. Robertson, a Federal Reserve Board Governor, has long been a critic of the regulatory scheme. During the 1965 hearings he was consulted extensively, and at one point said, "Today, it is accepted by thoughtful, disinterested, and responsible opinion that the unbalanced, dangerous, and injurious three way structure of Federal bank supervision must be replaced by a rational, unified system, that will enable the federal government to perform this function effectively, economically, and constructively."[21]

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[21] *Ibid.*

Thus in summary, the regulatory agencies were formed individually as a result of different causes. This has led to an overlapping of duties and authority, and the resultant overlapping system has received criticism from a variety of sources.

CHAPTER III

BANK SUPERVISION TODAY

To develop an idea of the three agencies as they are today it might be of some value to quickly look at their comparative sizes.

A physical comparison of the three indicates that the examining staff of the Federal Reserve is much smaller than the staffs of the other two.

Using the number of examiners as a basis for comparison is necessary because the Comptroller of the Currency and Federal Reserve examiners are part of much larger organizations, having many more functions than the Federal Deposit Insurance Corporation.

The Comptroller has the largest examining staff of the three with approximately 1350 employees performing that function. The FDIC is of similar size, having an estimated 1100.[1]

Though it has fewer personnel actually examining, the FDIC is responsible for checking more banks than the Comptroller, since there are more state, non-member, insured banks than there are national banks.

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[1] Eli Shapiro, Ezra Solomon, William L. White, Money and Banking (New York: Holt Rinehart and Winston, Inc., 1968), p. 183.

The Federal Reserve's smaller staff has only about 240 bank examiners with a correspondingly smaller responsibility in terms of numbers of banks to examine, only 1350 or so, whereas the FDIC and the Comptroller check roughly 7300 and 4800 respectively.[2]

COOPERATION AMONG THE AGENCIES

As mentioned on a preceding page of this paper, some banks are subject to three different supervisory agencies. For example, a national bank in theory could be examined by the Comptroller of the Currency, the Federal Reserve System examiners, and the Federal Deposit Insurance Corporation. But in practice, instances when that has happened are extremely rare. The various agencies have removed some of the overlapping activity from their overlapping responsibilities.

In 1938, not long after the FDIC was established, an agreement was reached between the agencies charged with regulating the nation's banks. The intent of the accord was to eliminate some of the duplication of effort inherent

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[2]Examining staff sizes of the three regulators are estimates obtained from officials in the Kansas City, Missouri, offices of each agency.

in the legislative make-up of federal bank supervision.[3]

As a result of the agreement, the Comptroller of the Currency has primary responsibility for national banks. State banks are supervised usually by the proper state authority and one of the other federal agencies, unless the bank is uninsured, in which case only the state examines it.

Whether or not the insured state bank is a member of the Federal Reserve System is the determinant of which federal regulator participates with the state in examinations. If the bank is not a member, then the Federal Deposit Insurance Corporation is the government examiner with first responsibility. On the other hand, if it is a member, the Federal Reserve System's checkers do the work.[4]

Thus, having allocated who is to examine which bank, there is, in practice, less confusion than would be expected from looking at the statutory duties of the various federal agencies.

A number of other steps have been taken and efforts made to minimize the conflicts.

For example, when both the state and the federal

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[3]George E. Lent, "The Changing Structure of Commercial Banking," _Tuck Bulletin No. 24_ (Hanover, New Hampshire: Dartmouth College, The Amos Tuck School of Business Administration, 1960), p. 7.

[4]_Ibid._

government have an interest in a particular bank, the two often agree to examine on the same day or days with the hoped for effect of reducing the bank's disruption below what it would have been had they examined on different days.

Another instance of supervisory cooperation that no doubt the banks appreciate is the occasional willingness of the state and federal authorities to accept each others examinations. When this is the case not only the bank gains but the agencies involved can carry out their functions with fewer actual appearances.[5]

However, a note of caution is appropriate. "While cooperative arrangements have been worked out among the various governmental agencies by which banks are generally not subjected to separate examinations by more than one authority, the power to examine banks is possessed by several agencies and this power can be used."[6]

OTHER COOPERATIVE EFFORTS

Other attempts at smoothing the differences were made in 1938. "A uniform report form was prepared by the three federal agencies and approved by the executive committee of

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[5]Shapiro, Solomon, and White, *op. cit.*, p. 192.

[6]*Federal Reserve Annual Report, 1938* (Washington: Board of Governors of the Federal Reserve System, 1938), p. 4.

the National Association of Supervisors of State Banks."[7]

In addition, the state and federal organizations concerned with bank supervising also adopted some uniform examining policies in 1938.[8]

At that time, it was believed the move was "the first constructive agreement among all supervisory authorities in their approach by examination to measure the soundness of banking institutions under their respective jurisdictions."[9]

In other words, even though the objectives of the agencies had been generally the same up to this time, their standards and methods had been different. So the policy collaboration was an attempt to remove some of the variety of reports and hopefully make the results more meaningful.

The approach of the policy accord was to establish equitable rules to be used in testing the soundness of a bank's major asset groups--loans and investments. By doing so the assets of different banks, whether state, national, insured, uninsured, etc., could be compared even though different agencies did the examining.[10]

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[7] Shapiro, Solomon, White, _op_. _cit_., p. 193.

[8] _Federal_ _Reserve_ _Annual_ _Report_, _1938_, _op_. _cit_., p. 15.

[9] Elwood M. Brooks, "New Program of Uniform Procedure Outlined and Interpreted," _Bank_ _News_, XXXVIII (August, 1938), 9.

[10] _Ibid_.

The agreement standardized loan and bond classifications into four groups and, among other things, provided for uniform treatment of securities profits.[11]

SOME SIGNS OF DISCORD

Possibly it was the coordinative efforts discussed above, or something similar that encouraged the previously mentioned Mr. Glenn Goodman of the Federal Reserve to say:

> The Federal bank supervisory agencies have different responsibilities and, to some extent, different approaches to the question of supervision. However, there is close cooperation among the staff members of the three Federal agencies in Washington and at the District level. Consultation is had on important bank supervisory developments in order to seek uniformity of policy where practicable.[12]

Whatever conditions prompted Mr. Goodman to such an opinion must have been of a temporary nature because about ten years later the Secretary of the Treasury, Douglas Dillon, under Presidential direction, was trying to establish the close cooperation, consultation and uniformity of policy that Mr. Goodman believed to have existed in 1953.

In general, Secretary Dillon's efforts consisted of

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[11]Ibid.

[12]Glenn M. Goodman, "Bank Supervision in the United States," Lectures Before the Center for Latin American Monetary Studies (Washington: Board of Governors of the Federal Reserve System, 1953), p. 11.

setting up procedures calling for the leaders of the three federal bank examining agencies to hold discussions before acting on issues where differences of opinion were believed to exist between the agencies.[13]

Apparently Secretary Dillon's coordinative efforts weren't the needed remedy because, if anything, the situation has deteriorated, as is illustrated in some of the following sections.

But as has been shown, the coordinative approach to problems resulting from the supervisory structure has been of some value. Primary regulatory responsibilities have been allocated, on occasion the agencies exchange examination reports, a uniform report form has been adopted, and some policy accords have been attained.

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[13]United States House of Representatives, Consolidation of Bank Examining and Supervisory Functions, Vol. Y5B22/89.1C73H (Washington: Government Printing Office, 1965), p. 79.

CHAPTER IV

CRITICISMS OF BANKING SUPERVISION

The newspaper stories of recent years, the institutional studies, and the Congressional hearings that have had to do with the present federal system of bank supervision have all been brought on by and directed at what are considered the faults of that system.

Seven different situations are most often mentioned in the criticisms. Briefly they are:

1. Promoting the development of uniform supervision and examination policies is hampered;
2. The different agencies have been guided by different concepts of the purpose of bank supervision;
3. Three agencies entail greater expense in the regulation of banks than is probably necessary;
4. The present system has some bank supervision inefficiencies;
5. There is the potential for a competition of regulation laxity when three agencies have "overlapping statutory responsibilities";
6. Federal legislation affecting the banking area has been interpreted differently by the different agencies thus thwarting much of the desired effect; and,

7. The present system requires the Board of Governors of the Federal Reserve to split its time between such things as monetary policy considerations and bank supervision, both full-time jobs.

I. UNIFORM POLICIES HAMPERED

In 1950 Senator Douglas of Illinois, after some research, opinioned that one weakness of the present bank regulatory system is that it fails to promote uniform supervision and examination policies, but he refrained from concluding whether or not the weakness caused sufficient damage to merit correction.[1]

Senator Douglas wasn't the first to bring the subject up. Just months after the Federal Deposit Insurance Corporation was formed, as the third member of the federal government's bank supervisory team, an executive committee of the National Association of Supervisors of State Banks set to work seeking to obtain accord in principles and standardization of practices among the bank supervisors.

The association held that "the objective of all these agencies has been the same, yet each used different

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[1]United States House of Representatives, Consolidation of Bank Examining and Supervisory Functions, Vol. Y5B22/89.1C73H (Washington: Government Printing Office, 1965), p. 116.

standards and methods, the natural result of which has been confusing to banks."[2]

Diffusion of Authority

Laudable as the Association's objectives were, some believed them unattainable from the start. For example, about that same time the Federal Reserve Annual Report appraised the difficulty of establishing uniform policies in connection with bank examinations, as due to the diffusion of authority between three independent agencies.[3] Thus implying that the difficulty would remain as long as the diffusion existed.

The test of time has not contradicted the Fed's report. The authority is still diffused between the same three and their coordination doesn't seem to be improving: "In recent years these three agencies have experienced increasing difficulty in laying down uniform guidelines for banks and in exchanging information among themselves."[4]

So, if the conclusion is reached that three independent agencies working in the same field will have differences

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[2]Elwood M. Brooks, "New Program of Uniform Procedure Outlined and Interpreted," Bank News, XXXVIII (August, 1938), 9.

[3]Federal Reserve Annual Report, 1938 (Washington: Board of Governors of the Federal Reserve System, 1938), p. 4.

[4]Editorial in the Wall Street Journal, February 23, 1966.

of opinion as to which is the proper way to do the job, then the pertinent question is whether these differences are significant enough that they are interfering with bank regulation or are harmful to the banking industry. Either one would seem to be a mandate for whatever changes necessary to eliminate the differences.

Inter-Agency Differences

The existence of these differences was brought out during the Congressional hearings on the subject in 1963 and 1965. At one point of the 1965 hearings William S. Moorhead, U.S. Representative from Pennsylvania discussed the conflicts:

> . . . the Comptroller of the Currency ruled as eligible for bank underwriting certain bonds, theretofore (sic) considered ineligible as not being general obligation bonds. The Federal Reserve refused to permit State member banks to underwrite these same bonds.
>
> The State banks, thinking that they were unfairly treated, proposed as a legislative cure, to make all revenue bonds eligible for bank underwriting. The investment bankers, seeing a serious threat to their domain, set up a howl.
>
> Despite the fact that this produced the noisiest fight among the bank regulatory agencies, it was not the only case of difference of opinion.
>
> There is the question of whether "Federal funds" transactions are loans or not, and whether they are subject to statutory loan limitations. There is the question of whether indebtedness represented by subordinated notes and debentures is part of a bank's "capital stock and surplus." There is the question of whether savings deposit privileges are available to business corporations. There is the question of who

has supervisory authority of the international operations of national banks.[5]

As mentioned above, the real concern should be whether or not these differences, or others that might exist at some time, have an adverse effect on the banking industry or bank regulation.

The president of the National Association of Supervisors of State Banks sees a negative effect. He believes that the variances in attitudes and policies among the three federal agencies has led to a competitive disparity between the state and national banks.[6]

Differences are Harmful

One result of this disparity has been what the State Supervisors analyze as a dangerous trend toward polarization of all banks to national charter. Later sections of this paper are devoted to the relationship between the bank supervisory set-up and charter conversions.

Some critics of our present system of bank regulation leave little doubt that they see the differences between the agencies as harmful. For example, Governor Robertson of the Federal Reserve has written:

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[5]United States House of Representatives, _op_. _cit_., p. 79.

[6]Phillip Hewes, "Outlook For Charter Conversions," _Banking_, LXI (October, 1968), 48.

> During the past five years the delicate balance of the banking industry has been upset, the dual banking system endangered, and the development of banking on sound lines impeded by the divergent policies, procedures and interpretations emanating from the three federal supervisory agencies.[7]

He insists that the only way to solve these problems and achieve the competitive equality necessary for our banking system is by instituting "uniform standards of regulation as far as federal law is concerned, and by modifying the rules and the laws on the basis of careful study of experience and thoughtful analysis of the likely consequences."[8]

In summary, the present bank supervisory arrangement may be hampering the development of uniform supervision and examination policies to a sufficient extent that corrective action is needed.

II. SUPERVISORY PURPOSE VARIES

As seen in the previous section, one result of the three-branched federal banking regulation is the difficulty of establishing uniform supervision and examination policies. Some writers have found other reasons for criticizing the present system. For example, "some evidence exists to

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[7] James L. Robertson, "Banking Is Speeding On the Wrong Side of the Road," _The Commercial and Financial Chronicle_, CCVIII (October 7, 1968), 18.

[8] _Ibid._

indicate that on occasion the different agencies have been guided by different concepts of the purpose of bank supervision and examination."[9]

Briefly, the criticism refers to a controversy over which objective should be stressed in banking regulation: safety or efficiency?[10] An even finer distinction is sometimes mentioned. If the purpose were safety, is it the safety of banks' depositors or the banks themselves that is of the utmost concern?[11]

How these questions are answered by each of the bank regulators will determine to a large degree just what role the institutions they govern will have in their respective communities. Quite a range exists from which that role can be determined.

An extreme, conservative regulator emphasizing safety and the maintenance of solvency in the banking system would demand tight restrictions on what types of assets and liabilities a bank could have. Such a situation could unnecessarily diminish the value of a bank to the community by limiting the funds available to local interests because the banks were made to hold excessive amounts of "safe"

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[9] Eli Shapiro, Ezra Solomon, William White, Money and Banking (New York: Holt, Rinehart and Winston, Inc., 1968), p. 196.

[10] *Ibid.*, p. 116.

[11] *Ibid.*

assets (i.e., government securities).

An extreme, liberal regulator, on the other hand, emphasizing the efficiency of the banking system would seek a near laissez faire atmosphere allowing banks a great deal of initiative to seek out new and better ways of doing business. Banks in this type of situation would likely be highly accessible sources of funds to a community, willing to do higher-risk business for higher-risk profits. But these banks, themselves, would be riskier.

Admittedly, the three bank supervisory agencies are far removed from either extreme, however it is highly unlikely that their positions within that range would be the same; and this variety of opinion among the examiners as to the purpose of their work doesn't facilitate a smoothly functioning banking system, as is seen in later sections of this paper.

Duties are not the Same

The main reason the three agencies would not attach identical purposes to their supervisory duties lies in the fact that their responsibilities are not identical

> The Comptroller of the Currency is primarily a supervisory and examining agency and is interested principally in matters affecting the status of individual banks. The Federal Deposit Insurance Corporation is primarily an insurance agency and is, therefore, primarily concerned about the protection of the insurance fund. The Board of Governors, in addition to its supervisory responsibilities, is concerned

> with national credit and monetary policies, and is, therefore, interested in supervisory policies that are in conformity with credit policies.[12]

Thus, it seems probable, that with the present three federal organizations responsible for supervising banks and banking, three concepts of the purpose of bank supervision will exist. Logically, this situation would seem to work to the disadvantage of the industry, though, by itself, the difference-of-purpose question may not be significant enough to merit changes in the regulatory structure. However, conflicts cannot be that neatly isolated; they must be considered in conjunction with the other related questions included in this paper. When that is done, the case for structural revamping is much more impressive.

III. EXPENSES COULD BE REDUCED

Those advocates of consolidating bank examining functions generally point out the probable reduction of operating costs if the move were made. One wrote: "Long before the principal personalities became locked in a mortal bureaucratic conflict, it was obvious that the trifurcated system Federal supervision was . . . needlessly expensive."[13] In

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[12] Federal Reserve Annual Report, 1938 (Washington: Board of Governors of the Federal Reserve System, 1938), p. 15.

[13] Editorial in the Washington Post, April 11, 1965.

other words, the expense of maintaining three banking supervisors is needless where one or two would suffice.

However, this section of the paper is not intended to reach a conclusion that the three federal regulators should be merged into one or two, but when considering such structural change, operating expenses should be a factor.

Not all authorities on the subject agree that financial advantages are to be gained by reducing the number of supervisory agencies. Mr. F. R. Peterson, former vice-president of the American Bankers Association, has expressed doubts that any "economies of scale" would result from combining one or more of the regulators.[14] He neglected to mention why there were doubts.

The Brookings Institute study had few doubts that savings were possible. In fact it was concluded that unification offered "considerable economy." It would eliminate the duplication of overhead costs in the maintenance of central and regional supervisory offices for three sets of examiners.[15] For example, there is a separate office in Kansas City, Missouri, for each of the three agencies.

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[14]F. Raymond Peterson, "Don't Destroy Dual Banking System," The Commercial and Financial Chronicle, CLXIX (February 24, 1949), 21.

[15]Report of Brookings Institution to the U.S. Congress (1937-1938), Congressional Service No. 10078, p. 215.

In addition,

> While there is no duplication of examinations . . . travel expense would be lessened if, for instance, a national bank and a state bank in the same town were examined by the same examiner on the same trip. Moreover, there would be a very considerable saving in the expense of reviewing examination reports. At present the reports of the national banks are reviewed in the Comptroller's Office and again in the office of the Federal Deposit Insurance Corporation, while reports of examinations of State member banks are reviewed in the Federal Reserve System and again in the Federal Deposit Insurance Corporation.[16]

Thus, with the lowering of travel expenses and the reduction of time needed to review examination reports, two examples are available of how consolidation of bank examining functions could help cut operating costs of the total regulatory task. As mentioned, such a possibility merits consideration when deciding on the need or lack of it for structural changes.

IV. COMPETITIVE INEQUITIES

"We should not forget that the present jerry-built structure of federal bank supervision, divided as it is among three different agencies, is an historical accident that does not rest on any defensible foundation of efficiency, equity, or economy. Its effect is to deprive banks of a reliable and competitively fair basis for the development

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[16] _Ibid._

of their plans and policies."[17]

The above quote from J. L. Robertson, Federal Reserve Board Governor, mentions what may be the most widely accepted criticism of today's bank regulatory set-up: namely, that it is a source of competitive inequities.

The basis for this contention is the fact that the different types of banks can have different agencies primarily responsible for them. Thus on any particular policy, one regulator, (A), may be more restrictive than its counterpart, (B), making the circumstances different under which A-type banks compete with B-type banks. When this is multiplied by the large number of policies and regulations existing plus the factor of three agencies instead of just two, it becomes obvious why competitive conditions vary among the different type banks.

Governor Robertson made this point particularly well while giving testimony during the 1965 Congressional hearings.

> Today, different Federal supervisors are applying different rules to banks, even though they sometimes reach this result in the process of interpreting the same statute that Congress meant to apply uniformly to banks. Eliminating conflicts of this sort will permit one banker to compete on the same terms as another, as far as the Federal government is concerned, and this

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[17] James L. Robertson, "Banking Is Speeding On the Wrong Side of the Road," The Commercial and Financial Chronicle, CCVIII (October 7, 1968), 18.

will enhance the ability to compete among banks.[18]

Competitive Complaints

In recent years, the Comptroller of the Currency (especially when James J. Saxon was chairman) has been much more liberal with the banks it controls than has the Federal Reserve System. As a result the "unfair" screams have been "coming not from national banks supervised by the Comptroller, but from state banks which in competing with national banks have been hobbled by the Fed's less liberal policies."[19]

Seeing a great deal of danger and potential for harm in the competitive situation, the National Association of Supervisors of State Banks held a conference with the Federal Reserve Board during the summer, 1968. A number of ideas came out of the conference that are covered in later sections of this paper.

The Association, determined to improve the competitive status of state banks, regarded the conference as "only one step in NASSB's program to redress inequities in the operations of state and national banks. We are now

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[18] United States House of Representatives, Consolidation of Bank Examining and Supervisory Functions, Vol. Y5B22/89.1C73H (Washington: Government Printing Office, 1965), p. 85.

[19] Herbert Bratter, "The Fed Reacts to Criticism," Banking, LXI (October, 1968), 44.

considering changes in the Federal regulatory structure."[20]

V. RACE OF LAXITY THEORY

As seen in the previous section, banks supervised predominantly by one regulator operate with different competitive conditions than banks supervised predominantly by another regulator. This variety of competitive conditions is believed by some to be the initial phase of a cycle occasionally referred to as the "race of laxity."[21]

The theory is that when the difference in competitive situations between one type bank (i.e., state, member) and another type (i.e., national) vary to the extent that one is at a competitive disadvantage, the disadvantaged banks will seek more lenient treatment from their present supervisors.

Should their pleas be turned down some of the banks will make changes designed to bring them under the control of a different supervisor, such as changing their status from member to non-member or changing their charter from national to state.

If the movement out of the control of one agency to the control of a different agency becomes a significant

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[20] Hewes, loc. cit.

[21] J. L. Robertson, loc. cit.

trend it puts a certain amount of pressure on the agency whose ranks are being depleted.

Pressured to halt the outflow or reverse the trend, the agency will begin making concessions to its subjects that it would not otherwise have made. The new permissiveness swings the pendulum the other way, causing the banks regulated by one or both of the other agencies to believe their competitive position deteriorating, which sets the stage for the cycle to begin anew. Thus the potential for competitive regulation laxity is present if each agency merely tries to keep its banks satisfied with their competitive positions. Data that tend to support the theory are given in the following sections.

<u>Supervisor Switching</u>

During the Congressional hearings of 1965, Governor Robertson of the Federal Reserve and Representative Multer of New York emphasized their belief that supervisor-switching is used as a tool to obtain a different competitive position. The following excerpt is a portion of that testimony:

> MR. ROBERTSON: . . . each one (federal agency) controls in its own little bailiwick the banks that are subject to its supervision and so it can give them privileges which these others can't have and if it thinks it can get more members under it and then enhance its power, it will relax its supervision and that causes these banks over here to convert in order to take advantage of the situation.
>
> MR. TALCOTT: Have there really been some actual instances of this?

MR. ROBERTSON: There have been a great number of instances where banks have switched from one charter, State to a National, in order to get lesser supervision. Some have admittedly said they were doing it so they would merge when they couldn't do it under the Federal Reserve.

MR. TALCOTT: Do we have documentary evidence?

MR. ROBERTSON: . . . I can give you one which I think will be satisfactory for your purposes of a situation where a merger was turned down by the Federal Reserve. The institution immediately converted to a national bank, one of the institutions, and thereafter a merger was approved of the national, by the Comptroller of the Currency.

MR. TALCOTT: Can you give a specific situation?

MR. ROBERTSON: I would prefer not.

MR. MULTER: Suppose you give it to Mr. Talcott off the record.

MR. ROBERTSON: I will be glad to.

MR. TALCOTT: I am concerned whether we have valid reasons to be fearful.

MR. ROBERTSON: I can assure you we do have reasons.

MR. MULTER: May I at this point confirm to you what Governor Robertson has said. I know of any number of instances and it can be furnished to you and I think it would be wise if they be furnished off the record, where an attempt has been made to merge or to branch by a State or National bank, and the application was denied. The next thing we knew the bank had converted to the State or National system as the case required and the application granted.[22]

A Conversion Trend

The extent of this switching has become quite pronounced during the 1960s. A trend has emerged with conversions from state to national charter greatly exceeding the number of conversions in the opposite direction. The amount of assets involved in such conversions has been overwhelmingly

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[22]United States House of Representatives, op. cit., p. 106.

in favor of national banks, as shown by the data in Table I supplied by the Comptroller's office.[23]

TABLE I

BANK CHARTER CONVERSIONS

State to National			National to State		
Year	Number	Total Assets in Millions	Year	Number	Total Assets in Millions
60	14	$ 349	60	6	$ 25
61	8	315	61	1	2
62	18	285	62	8	94
63	26	437	63	11	103
64	27	2164	64	6	39
65	25	12867	65	8	111
66	23	910	66	8	97
67	11	243	67	5	21
Total	152	$17571		53	$491

Source: Bratter, loc. cit.

The net effect for the first eight years of this decade, as shown in Table I, is that the state banks were within one of losing a hundred institutions to the national charter. Even more staggering, that loss has amounted to over 17 billion dollars in assets--not a pittance!

[23]Bratter, loc. cit.

The situation has not gone unnoticed. In 1967, Mr. Willis W. Alexander, President of Trenton (Mo.) Trust Company and American Bankers' Association vice-president at the time, called attention to the fact that in all but one of the ten largest cities west of the Mississippi River the two largest banks have or are in the process of getting national charters.[24]

Two notable examples of the flight to national charter are the Wells Fargo Bank of San Francisco and the Wachovia Bank of Winston-Salem, N.C., both of which converted during the spring, 1968.

The shock of losing two banks of billion dollar size spurred the National Association of Supervisors of State Banks to form a commission for study of the conversion movement.

> The conversions this spring of Wachovia Bank and Wells Fargo Bank from state to federal charter were a catalyst. They demonstrated that state banks, particularly the large member banks, were deeply distressed over a deteriorating competitive position with respect to national banks.
>
> One glaring conversion cause pinpointed in both the Wachovia and Wells Fargo charter changes is the policy conflict between the Comptroller of the Currency and the Federal Reserve Board. Their differing inconsistent attitudes in the past have resulted in a competitive disparity with large state member banks getting the short end of the stick.[25]

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[24] Ibid.

[25] Hewes, loc. cit.

Seeking the Conversion Cause

This pronouncement by the NASSB that the culprit behind the conversion dilemma is the regulators' "differing inconsistent attitudes" represents a much broader view than was taken by the Association before the conference, when it was identifying symptoms rather than causes. For instance, an article appearing in the Wall Street Journal shortly before the conference included the following sentence:

> One reason for the conversion trend, the association said, is that large state member banks are prohibited by the Federal Reserve Board from operating subsidiaries, while their competitors, the large national banks, which are under supervision of the Comptroller of the Currency, aren't so restricted.[26]

Certainly the withholding of freedoms from some banks when others are not likewise restricted can lead to dissention and such manifestations of it as charter switching. But, to stop there seems to prematurely end the probing. The question to ask is what situation fosters the unequal treatment that leads to dissention and ultimately movements from state to national charters?

Apparently when the NASSB asked this question during the conference it looked past such answers as "they aren't allowed to operate subsidiaries" in favor of "the regulators' differing inconsistent attitudes," and thus focused attention much closer to the real problem.

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[26] The Wall Street Journal, July 1, 1968, p. 15.

Regulatory Pressures

As mentioned in the race of laxity theory, there is pressure on the more restrictive supervisor(s) to ease the controls and allow greater freedoms to the banks involved. The most influential form this pressure takes is when banks begin changing their supervisor through such methods as charter switching.

However, on occasion the pressure becomes more overt in nature. For instance:

> During the American Banking Association's international monetary conferences at Dorado Beach, Puerto Rico, last May (1968) . . . leading bankers present and Charles E. Walker, speaking for the ABA, directed sharp criticism at Federal Reserve Supervision.
>
> Several members of the Board of Governors were present and Chairman Martin, for one, was deeply impressed with the need to examine remedial measures.[27]

Whether the pressure takes the more apparent form of bankers and supervisors openly criticizing an agency or the more subtle, and much more powerful appearance of numerous charter conversions, it does exist and it does influence the banking industry. As was seen in the previous section, the same can be said for the heterogeneous competitive conditions fostered by the three-boss system in banking.

If the race of laxity theory were to be upheld, the pressure must cause the agency being squeezed to make

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[27]Bratter, loc. cit.

concessions to its subjects that it would not otherwise have made.

Summarizing, the variety of competitive conditions exist; as a result, many banks have believed themselves suffering from an unnecessary competitive disadvantage; apparently their pleas for relief have gone unrewarded; thus a very discernible conversion trend has developed during recent years; this trend has been the major source for the enormous pressure put on the Federal Deposit Insurance Corporation and the Federal Reserve.

And, to complete the cycle, some observers believe the pressure is already obtaining results that the pleas for relief couldn't:

> During the past few months we have seen important decisions made under pressures that are directly traceable to the irrational structure of our supervisory system. As you all know, my own agency (the Federal Reserve System) recently reversed its position on two fundamental matters.[28] In doing so, it was tying (sic)

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[28]Some readers might want to know on what "two fundamental matters" the agency reversed its position. That fact was never precisely stated in the reference. However, judging from the context of the article, the reversals probably were in the area of one-bank holding companies and other attempts at diversification by state banks.

An article written by Phillip Hewes for the October, 1968, issue of Banking states that certain regulations governing state member banks were eased as a result of a conference between the Federal Reserve Board and the NASSB. "One change permits stock acquisitions in subsidiary corporations. The other authorizes so-called 'loan production offices.'"

> to correct a competitive imbalance, brought about by the decisions of another agency, which threatened the very existence of a strong dual banking system. Competition among the regulatory authorities was breaking down not only the legal barriers to banking practices which had previously been judged unsound, but also our traditional banking structure. To preserve the structure, the law was bent to permit what it seemed clearly designed to prohibit.[29]

It is doubtful that the preceding pages establish the existence of the race of laxity, but little would be lost if those pages are successful in demonstrating the presence of circumstances which could cause the race to develop in earnest, or that aggravate the situation if it is already operating.

Thus whether or not the race exists need not be the only important question to be answered. There is merit in determining whether or not the present situation in banking encourages such a race of laxity. It does.

VI. THWARTING LEGISLATION

One serious charge made against the present structure of federal bank supervision is that the different regulatory agencies have on occasion interpreted new federal legislation differently with the net effect of thwarting much of what the legislation was designed to produce.

If one of the desired effects of the 1960 Bank Merger

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[29] James L. Robertson, loc. cit.

Act was to provide a consistent, equitable policy on what is acceptable and unacceptable in merging, then it is probable that such intent has been to a certain extent frustrated.

The Act provides that banking authorities should have the final decision of approval or disapproval of bank mergers after consultation with the Justice Department. But since three different federal agencies supervise banks the responsibility had to be divided. The Comptroller of the Currency has final say for national banks; the Federal Reserve for state member banks, and the Federal Deposit Insurance Corporation for non-member banks.[30]

Thus there are probably three different sets of criteria regarding bank mergers which hardly seems necessary or equitable.

A case where the thwarting of legislative intent was much more obvious concerns the Securities Exchange Commission Act. In 1964 Congress decided to make publicly held banks conform to the Act just as other businesses must.

One of the provisions of the Act is that the businesses involved must make available, to the public, data to assist them in making an informed investment decision. In complying with this directive the different agencies have used dissimilar approaches in presenting the data and do not make

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[30]United States House of Representatives, _op_. _cit_., p. 82.

it available in the same places, testified Governor Robertson during the 1965 House Hearings.

Consequently, interested parties are apt to find themselves comparing apples and oranges, if they are able to get the two together.

Robertson concluded that due to each of the three federal supervisors applying the law differently, investors have been deprived of the benefits that Congress attempted to confer.[31]

If a thorough investigation substantiated what the witness said and indicated that such deprivation of benefits was likely to occur again it would seem a remedy is demanded.

For the purposes of this paper it is sufficient to note that the instances described above are liabilities for a structure that is in need of assets to justify its existence.

VII. AN OVERLOADED FEDERAL RESERVE

As has been seen in this paper, one function the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency have in common is that they all supervise commercial banks.

For the Comptroller and the Federal Deposit Insurance

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[31] Ibid.

Corporation, "bank supervision," in the broadest use of the phrase, describes their whole job. Not so with the Federal Reserve System.

The Fed's primary responsibility is in the area of monetary policy, that is, "fostering a flow of credit and money that will facilitate orderly economic growth, a stable dollar, and long-run balance in our international payments."[32]

Thus it would appear the Board of Governors running the Federal Reserve is strapped with two full-time jobs, bank supervision and monetary policy.

During the 1965 House Banking and Currency Subcommittee Hearings some emphasis was placed on this dual function of the Fed and the time demanded of the seven members of the Board. Of those who offered opinions on the subject there was agreement the load was excessive and there existed the possibility that one or both jobs might be deprived of sufficient attention.

Mr. J. L. Robertson speculated that if the bank supervisory function of the Fed was lifted "it would enable the Federal Reserve Board, of which I am a member, to devote its time and attention exclusively to its most vital--and increasingly difficult--function, the formulation

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[32]The Federal Reserve System, Board of Governors of the Federal Reserve System (Washington, D.C.: 1963), p. 1.

and execution of monetary policy for the leading industrial nation of the world."[33]

Possibly this dual-function dilemma could be solved easily, by dividing the Board's responsibilities, making some of the governors responsible only for supervising and the others for monetary policy. However, this is entirely another matter, not to be considered here.

At present, the Fed is not set up that way, and the dual-function dilemma appears to be another disadvantage of today's bank regulatory structure.

One other disadvantage of today's supervisory arrangement, even admitted by former Comptroller James J. Saxon (an outspoken defender of the present regulatory structure), is seldom mentioned. It concerns the belief of "most observers . . . that a clear separation between monetary policy authority and bank supervisory functions is desirable."[34]

Saxon believed "serious questions" could be raised about the wisdom of combining the two. His reasoning was that sometimes the two jobs conflict, creating the risk that the supervisory powers would be used "to effectuate

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[33]United States House of Representatives, _op_. _cit_., p. 83.

[34]Charls Walker, "Dr. Walker Comments on Proposals to Reform Federal Bank Supervision at New York Convention," _Banking_, LV (August, 1962), 57.

monetary policy in a manner detrimental to the effective functioning of the banking system."[35] Such a risk exists today in the Federal Reserve System.

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[35]James J. Saxon, Freedom On Conformity, United States Treasury, May 6, 1964.

CHAPTER V

IMPROVING FEDERAL SUPERVISION

In general, there are only two types of proposals for improvement of federal bank supervision. One group advocates maintaining today's three-way structure, but making changes designed to eliminate the present conflicts. The other group includes those who suggest consolidating the supervisory functions of the three agencies into one.

Greater coordination of efforts among the three agencies seems to be the most popular solution for those on the side of keeping three federal regulatory agencies.

INTER-AGENCY AGREEMENTS

As discussed in a previous section, a number of attempts at greater coordination have already been implemented with varying degrees of success. The 1938 agreement, reached by the agencies, which assigns primary supervisory responsibilities for the different type banks has been successful in eliminating some of the potential overlapping. For example, national banks are generally examined only by the Comptroller of the Currency even though the law provides for all three to do so.

Other 1938 agreements of less significance were the uniform report form and the uniform examining policies discussed in preceding parts of this paper.

During recent years, further attempts at coordination have met with less success. Secretary of the Treasury Dillon's endeavors at the urging of President Johnson have apparently been of little consequence. Dillon asked each agency to consult with the other two and the Secretary before acting on matters considered controversial. Inter-agency problems seem to have grown, if anything, since that sterile request.

The American Banking Association has suggested something similar to Dillon's approach, calling for "close, periodic consultation among the existing three agencies."[1] At face value, consultation seems quite insufficient as any kind of remedy for the present inter-agency differences. Why should it be of any more value now than it was when Secretary Dillon made the attempt?

A Wall Street Journal editorial, in a similar vein, attached little value to "compelled conferring:"

> Nor is it especially helpful to propose, as other well-meaning bankers do, that the three agencies merely be compelled to confer with one another on any matters that may be controversial. That idea might move controversies from newspaper headlines to quiet conference rooms, which certainly would be more dignified. But as long as the agencies' powers continue to overlap the costly and confusing battles are likely

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[1]The Wall Street Journal, May 3, 1965, p. 8.

to continue.[2]

However, if the requirement for consultation were to become some kind of a legislative fact then maybe the basis for progress would be established. For instance, if the decisions of a deliberative body composed of the heads of the three agencies, the head of the National Association of Supervisors of State Banks, and the Secretary of the Treasury were made binding on bank examiners the potential influence of the consultations seems to be greatly enlarged.

The ABA has gone on record for some legislative activity in the area of bank supervising. The Association wants the lawmakers to more clearly define the jurisdiction of each agency.[3] The potential value of such legislation is impossible to determine without more specifics, which don't seem to be available. Nevertheless, jurisdictional disputes have been one of the problems and likely will continue to be, so efforts in this direction shouldn't be ignored.

MANY FORMS OF CONSOLIDATION

Those calling for consolidation of the three government regulators have included the gamut of possibilities: combining all three in the Federal Reserve System, or in

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[2]Editorial in the Wall Street Journal, April 21, 1965.

[3]Wall Street Journal, loc. cit., May 3, 1965.

the Treasury or in the Federal Deposit Insurance Corporation or removing all supervisory powers from the three and placing them in a single new agency.

The proposal least likely to be adopted seems to be the one brought out in 1961 by the government's Commission on Money and Credit. The Commission suggested that the functions of the FDIC and the Treasury's Comptroller of the Currency be transferred to the Federal Reserve.[4]

"Few people have come to the support of this recommendation, primarily because such a transfer would further burden an already overburdened Federal Reserve Board."[5]

Another call for consolidation, this time around a different agency, was in 1965 when Rep. Wright Patman, Chairman of the House Banking Committee, introduced bill H.R. 6885 in the House. If enacted, the bill would have put all the regulators under the control of the Treasury.[6]

Like the other two, the FDIC has also been a proposed center of a consolidation plan. That proposal came in the 1938 report of the Brookings Institute to Congress.

In brief, Brookings recommended eliminating the

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[4]Charls Walker, "Dr. Walker Comments on Proposals to Reform Federal Bank Supervision at New York Convention," Banking, LV (August, 1962), 57.

[5]Ibid.

[6]Wall Street Journal, May 3, 1965, p. 8.

office of the Comptroller of the Currency; having the Federal Reserve handle all credit and monetary considerations, and making the Federal Deposit Insurance Corporation responsible for the examination of all insured banks.[7]

The Brookings Report concluded "It is impracticable . . . to carry through the unification in any other agency than the Federal Deposit Insurance Corporation."[8] Various reasons for this conclusion were offered.

One reason was that many insured state banks are not members of the Federal Reserve System and are thus subject to federal examination only because they have elected to take advantage of the insurance of deposits which is administered by the Federal Deposit Insurance Corporation. So, "it would be out of the question to place the examination of these non-member banks with either the Comptroller's office, the Board of Governors of the Federal Reserve System, or the Federal Reserve Banks."[9]

Another reason cited in the report was the fact that "examination is more important to the Federal Deposit Insurance Corporation than it is to the Federal Reserve System. In fact the power to examine insured banks is essential to the proper performance of its duties by the FDIC."[10]

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[7] _Report of Brookings Institution to the U.S. Congress (1937-1938)_, Congressional Service No. 10078, p. 215.

[8] _Ibid._ [9] _Ibid._, p. 216. [10] _Ibid._

FEDERAL BANKING COMMISSION

The fourth alternative offered by the "consolidation group" is to do away with the three federal supervisors as we know them today, combining their responsibilities into a new agency commonly called the Federal Banking Commission.

Probably the most widely known champion of this alternative is the oft-mentioned Mr. James L. Robertson, Federal Reserve Board Governor. Robertson's five-man Federal Banking Commission gained legislative identity in 1965 as H.R. 107, a bill sponsored by Rep. Multer (N.Y.), head of the House Banking Sub-committee.[11]

Thus two bills of somewhat similar intent were in the House of Representatives during 1965. Of the two, Multer's (and Robertson's) H.R. 107 received more favorable reaction than the previously mentioned H.R. 6885 sponsored by Rep. Patman.

Patman dropped his consolidate-into-the-Treasury idea and has, since 1965, introduced a Robertson-type bill each year. In 1969 it is called H.R. 42.

H.R. 42 calls for the Federal Banking Commission, with five members to be appointed by the President to serve

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[11]Wall Street Journal, loc. cit.

staggered ten-year terms.[12] It also provides for all costs and expenses of the Commission to be paid for as costs of running the federal deposit insurance program.[13]

The objectives of the bill are threefold:

> 1. To provide for a more uniform, equitable, and efficient administration of Federal banking laws, by eliminating the present overlapping of regulatory jurisdiction, fragmentation of responsibility, and resulting conflicts of policy;
>
> 2. To permit the Board of Governors of the Federal Reserve System to concentrate upon its primary responsibilities in the field of monetary policy by relieving it of the additional burdens of functioning as an administrative tribunal and supervisory agency; and
>
> 3. To preserve and strengthen the principle of the dual banking system by charging a single impartial agency with the administration of Federal banking laws in consonance with that principle.[14]

The new Commission would assume, all bank examining and supervisory functions of the Fed (except with reference to Federal Reserve Banks), all functions of the Comptroller of the Currency (except currency issue and redemption functions which are tranferred to the Treasury), and all functions of the FDIC.[15]

Thus the Commission would have much the same authority

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[12]Wright Patman, <u>H.R. 42 A Bill</u>, U.S. House of Representatives, Banking and Currency Subcommittee (Washington, D.C.: January 3, 1969), p. 4.

[13]*Ibid.*, p. 9.

[14]*Ibid.*, pp. 1-2.

[15]*Ibid.*, pp. 5-6.

as the three agencies now have, without the addition of any new authority.

Arguments for and against the various proposals are included in remaining sections of this paper.

CHAPTER VI

SPOKESMEN FOR STATUS QUO

Despite the supposed faults and suggested improvements of the present system of federal bank supervision, there are many spokesmen for the status quo. To ignore these people, not only seems unfair, but would deprive most readers of a helpful contrast.

"Spokesmen for the status quo" needs some clarification, though. Very few have said the present arrangement is just fine and doesn't have any areas in need of improvement.

However, quite a few have decried the suggested improvements and others have dissented when certain conditions were called faults of the system, but at the same time have neglected to state where the faults do lie or to suggest improvements. Combined, the two are an implicit vote for the status quo.

Various reasons can be cited why some bankers look dimly on changes in bank regulation. A Wall Street Journal editorial offered one opinion:

> A number of bankers favor little or no change in the current distribution of supervisory powers among the Office of the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation. Their reasons for preserving the status quo are interesting, though somewhat less than persuasive.

> For one thing, some groups of bankers have their favorites among the Federal agencies. Rightly or wrongly, for example, State-chartered banks think the FDIC often tends to lean their way in policy disputes. Other groups have their own favorites and so oppose any proposals that might endanger the existence of the agency they prefer.[1]

How much of a factor the above reasoning is in the opposition to structural change may never be known because members of the banking industry seldom, if ever, voice it for the record.

Of the two types of proposals for improvement of federal bank supervision, discussed in a preceding section, the one calling for some form of consolidation is most often attacked. However, the other type, though much less controversial than consolidation, has not remained free of criticism.

For example, even the apparently harmless idea of seeking greater coordination of the three agencies is regarded as potentially harmful by some observers. Mr. James J. Saxon, as Comptroller of the Currency, saw disadvantages in the idea.

> Some have been content to ask for coordination, but this is a term which has different meanings to different people. To some it suggests that proposals on which there might be disagreement should be avoided. To others it suggests the retention of the status quo wherever differences cannot be reconciled. If coordination followed this course, it is clear that the most

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[1]Editorial in the <u>Wall Street Journal</u>, April 21, 1965.

> reluctant, the most fearful, and the least imaginative would always control the pace of change.[2]

The perceptive reader might note a conflict in the Saxon quote, above, where he expresses concern over the possibility that the pace of change could be controlled by those who embrace the status quo, when in fact, the reason for the quote is to illustrate an example of a spokesman for the status quo.

The conflict is only apparent. Saxon, as Comptroller, was very much a defender of the present structural set-up of federal bank regulation, however, at the same time he was a liberal innovator with regard to regulatory policies.

Thus, one reason he defended the status quo structure and feared greater coordination of the agencies was because he didn't want to be impeded on policy matters by the slower changing FDIC and Federal Reserve. He wanted the Comptroller's office to retain its freedom of action, and the best way to do so was to keep the same regulatory system and agency relationships. He also had other reasons for opposing regulatory change, as is seen later in the paper.

As mentioned, the proposal calling for some type of consolidation, whether it be within an already existing agency or through the formation of an entirely new one, is

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[2] James J. Saxon, Freedom or Conformity, United States Treasury, May 6, 1964.

the most vehemently criticized of the two.

THREATEN THE DUAL BANKING SYSTEM?

The principal reason for the opposition seems to be that many banking authorities regard consolidation as a serious threat to the dual banking system. Dr. Charls Walker, ABA executive vice-president, discussing J. L. Robertson's Federal Banking Commission proposal stated "there is little doubt that most of the debate concerning his or any similar proposal will revolve around the impact of its adoption upon the dual banking system."[3]

The position that consolidation would threaten the dual banking system is not a recent development. The combatants have been taking sides along these lines for years. Back in 1949, the FDIC's chairman, Maple T. Harl, responding to the Hoover Commission's call for consolidation of the FDIC into the Treasury, wrote "the recommendations pertaining to this Corporation suggest lack of understanding . . . to the extent that the independence of the Corporation is impaired the dual banking system is endangered."[4]

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[3]Dr. Charls Walker, "Dr. Walker Comments On Proposals to Reform Federal Bank Supervision at New York Convention," Banking, LV (August, 1962), 117.

[4]"Who's Against the Hoover Plan?," Fortune, XL (December, 1949), 95.

Harl's successor today, Mr. K. A. Randall, has expressed similar views on the subject.[5]

MORE SAXON OBJECTIONS

It comes as no surprise that Comptroller Saxon and his successor Camp, like their FDIC counterparts, would also see the preservation of the dual system as a major reason against consolidation. However, for Saxon, this reason and the one given earlier aren't the limit of his objections. There are at least three others.

One, he sees consolidation as a harm to the public good; two, it could be carried out only at the expense of individual freedom of expression, and three, it would deprive the banking industry of making its maximum contribution to the nation's economic growth and development.

The public good. With three agencies individually exercising discretionary powers, there is bound to be differences of opinion. "The tragedy to be feared is not that these differences will arise, but that they may be submerged in the interest of surface harmony and at the expense of the public good."[6]

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[5] _Wall Street Journal_, May 3, 1965, p. 8.

[6] Saxon, _loc. cit._

> Freedom of expression. It is an accepted view among political theorists that the dispersion of power is an essential safeguard to the preservation of individual liberty. Greater uniformity of policy may be achieved if all powers are centralized. But this can only be done by sacrificing individual freedom of expression.[7]

The banking industry's contribution. The diffusion of public authority that results from having three regulatory agencies offers prime protection against supervisory stagnation and thus the best hope that the banking industry is not deprived of making its maximum contribution to the nation's economic progress.[8]

MORE SUPPORT FOR STATUS QUO

The Comptroller's office and the FDIC aren't lone wolves in their support of the structure and relationships that make up today's federal bank supervision. The American Bankers Association and many individual bankers are lined up with them.

An ABA vice-president has written that maintaining a separate and independent status for each of the three agencies is necessary to preserve the dual banking system.[9]

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[7] *Ibid.*, p. 3.

[8] *Wall Street Journal*, *loc. cit.*

[9] F. Raymond Peterson, "Don't Destroy Dual Banking System!," *Commercial and Financial Chronicle*, CLXIX (February 24, 1949), 21.

The same man, F. R. Peterson, gave another reason for keeping three regulatory agencies. He felt they provide the checks and balances needed for the operation of a sound banking system. "The absorption of one of these agencies by another or the transfer of all or part of the functions of one of these agencies to another would tend to destroy these checks and balances--so necessary and essential."[10]

In 1962, Dr. Walker, mentioned above, forecast that the ABA's position on the consolidation issue would depend primarily on the expected impact of that type plan on the dual system.[11] His prediction, though not startling, is nevertheless accurate. The ABA regards consolidation to be a serious threat to the dual banking system and has, consequently, pledged the concerted and vigorous opposition of the banking industry against such a plan.[12]

For the ABA to take such a strong position indicates a confidence that the majority of Association members hold a similar view. An ABA survey conducted in 1962 upheld this confidence.

However, it should be noted that results of the survey showed something less than enthusiasm for the Association's anti-consolidation stance. Specifically, the

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[10] Ibid. [11] Walker, loc. cit.

[12] Wall Street Journal, loc. cit.

bankers were asked if they were in favor of J. L. Robertson's Federal Banking Commission proposal. A surprising 43 per cent of the replies favored it![13]

Another note of interest in the survey were the reasons offered by those who opposed the idea. The main opposition came from fear of loss of the dual banking system. The second most popular objection parallels Saxon's "dispersion of power" concept: Robertson's plan would mean too much concentration of federal power.[14]

Two other reasons appeared on at least 10 per cent of the opposing bankers' replies. One was that the Federal Banking Commission would involve too much politics, and the other was that it would upset the current system of checks and balances.[15]

All in all, of those who oppose change in the present federal bank supervisory structure, whether they be agency spokesmen, American Bankers' Association spokesmen, or individual bankers, their most likely position is that it would threaten the dual banking system, which is unthinkable in banking circles.

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[13] John W. Riday, Banking, LV (October, 1962), 46.

[14] Ibid., p. 47.

[15] Ibid.

CHAPTER VII

COMPARING ALTERNATIVES

As has been stated in the preceding pages, a number of criticisms are made of the present three-agency system of federal bank supervision.

1. It hampers the development of uniform supervision and examination policies;
2. The different agencies are sometimes guided by different concepts of the purpose of bank supervision;
3. Three agencies entail greater expense in the regulation of banks than is probably necessary with fewer agencies;
4. The present system leads to competitive inequalities among banks;
5. There is the potential for a race of laxity;
6. On occasion, federal legislation affecting the banking area has been interpreted differently by the different agencies thus thwarting some of the desired effect, and
7. The present system requires the Board of Governors of the Federal Reserve to split its time between monetary policy considerations and bank supervision, both full-time jobs.

Some observers do not accept all of these as valid criticisms. However, among those who do, there are various proposals to remedy the problems. In general, the proposals are of two types: keep the three agencies but provide better coordination between them; and consolidate the three agencies.

CASE AGAINST BETTER COORDINATION

The "better coordination" approach appears to have little permanent value, both for reasons noted earlier and two additional reasons.

For one thing, coordinative efforts among the three agencies can be an expensive undertaking, as Professor Klebaner mentioned during the 1965 hearings. He stated that even when successful, coordination is costly in terms of manpower. Klebaner added, Chairman Martin of the Board of Governors has conceded "from personal experience that the present structure does require that considerable time be devoted to liaison, coordination, cooperation and negotiation between the various parts into which the structure is divided."[1]

Also, time delays can be a source of danger when situations develop that need quick action.

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[1]United States House of Representatives, Consolidation of Bank Examining and Supervisory Functions, Vol. Y5B22/89.1C73H (Washington: Government Printing Office, 1965), p. 116.

> In one case, for example, an excessively long period of time elapsed between initiation of negotiations and the final consummation of a plan for the relief of a dangerous banking situation in an overbanked community in which were located two State member banks and a national bank, all in an unsatisfactory condition. The lapse of time was largely due to the fact that the plan for working out the situation had to be satisfactory not only to the local interests and to the State banking authorities, but to the federal agencies, also.[2]

In addition, relying on coordination to solve interagency problems is an unenlightened approach, for another reason, it amounts to a kind of crises management. That is, the regulators wait for conflicts to arise, then try to agree on how to handle them. What is more, in the past the agreements have sometimes been of a rather flimsy, and consequently temporary, nature.

A good example is the 1938 accord on uniform examining policies reached by the various supervisory authorities. One writer concluded his description of it with some unsettling remarks:

> It remains for the respective supervisors to determine what shall constitute adequate reserves . . . and . . . of course, supervisory authorities reserve the right unto themselves, in their sole discretion, to deviate from, or altar (sic), the foregoing principles.[3]

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[2] Federal Reserve Annual Report, 1938 (Washington: Board of Governors of the Federal Reserve System, 1938), p. 12.

[3] Elwood M. Brooks, "New Program of Uniform Procedure Outlined and Interpreted," Bank News, XXXVIII (August, 1938), p. 16.

On the basis of arguments given in this section and a previous section, this paper rejects any emphasis on better coordination of the three agencies as a long-range solution to the problems that beset today's system of federal banking supervision.

CASE FOR CONSOLIDATION

Whether the alternative, consolidation, has more or less merit won't be answered with any type of unanimity in the near future. Of the various proposals offered under the banner of consolidation, the Federal Banking Commission concept is the most noteworthy.[4] The detractors of such an idea stress its threat to the dual banking system; they also lament the loss of the "checks and balances" provided by having three agencies; also, they fear too much politics and an excessive concentration of power would accompany a Federal Banking Commission arrangement.

Putting aside the threat to the dual system, for the moment, the other objections mentioned above are questionable. For instance, why should there be more politics involved in picking the five-man Commission than is involved in selecting the Fed's Board of Governors? This year's Congressional bill, H.R. 42, includes a method of naming

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[4]See Chapter V.

the Commission members similar to the Federal Reserve's approach; it calls for career commissioners to serve staggered ten-year terms--about as apolitical as is possible for a public office.

The complaint that consolidation would create an "oppressive regulatory colossus" is sometimes heard. But no new authority is created, and the danger of combining it could be minimized if Congress would carefully define the new agency's powers, curtailing them where they seemed excessive.[5] As the Wall Street Journal has suggested: "It's true, as some bankers fretfully argue, that such an agency would be powerful. (But) the way to deal with that is to reduce the regulations, not scatter it helter-skelter among competing agencies."[6]

As for the dual banking system, instead of asking if it can survive consolidation of the regulatory agencies, why not ask if it can survive without consolidation?

"Recent conversions to national charters by Wells Fargo Bank, San Francisco, and Wachovia Bank & Trust Company, Winston-Salem, North Carolina, both billion-dollar institutions, have led to speculation that the dual banking

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[5]Wall Street Journal, February 23, 1966, p. 18.

[6]Wall Street Journal, April 21, 1965, p. 18.

system is struggling for survival."[7]

However, the point to be made is that a Federal Banking Commission proposal like H.R. 42 has fewer of the disadvantages and more advantages than the present three-supervisor system--unquestionably so, if any value is attached to the "race of laxity" theory.

There is even some evidence that the "grass-roots" bankers of the nation are near to agreement with the above statement. As mentioned earlier, the ABA survey found 43 per cent of the bankers interviewed in favor of a Federal Banking Commission structure. But what is even more significant about the survey, of those who voted against the proposal, most did so because they feared it would harm the dual banking system. Thus:

> It becomes apparent that all doubts as to the possible effects of the proposal on the dual banking system must be removed once and for all. When this is done, it should be safe to assume that the rather even division of conditional approvals and conditional disapprovals would be changed to an overwhelming majority.[8]

In other words, the vast majority of those bankers interviewed would support a Federal Banking Commission proposal, like H.R. 42, if it could be shown that such a structural change would not damage the dual banking system.

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[7] Wall Street Journal, July 1, 1968, p. 15.

[8] James L. Robertson, "Governor Robertson Views Banking's Survey Results, LV (November, 1962), 45.

It's extremely doubtful that could be proven without having tried an FBC system first.

Nevertheless, with the federal regulators involved in differences of opinion and conflicting policies, while the individual banks struggle against varying competitive conditions and a parade of charter conversions it becomes apparent that consolidation of the three agencies into a Federal Banking Commission is much more likely to preserve the dual banking system than today's regulatory structure.

CHAPTER VIII

CONCLUSION

Having examined problems that beset today's banking supervision and having discussed corrective measures suggested by various authors, I propose the creation of a Federal Banking Corporation to assume the responsibilities of and replace the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and that part of the Federal Reserve System concerned with the regulation and supervision of banks.

My proposal has much in common with what James L. Robertson has advocated, however there are differences, discussed later.

The Corporation would have only the authority possessed by the three existing agencies, however, the combining of it in one organization would automatically relieve some of the problems those three are presently contending with.

For example, it would end duplication of effort and facilities, plus the law would no longer need to provide for overlapping jurisdictions, authority and duties.

Presiding over the Corporation would be a five-man Federal Banking Board, with its members appointed by the President and confirmed by Congress. If each of the Board members served ten-year terms of office, staggered to have one end every two years, political influence could be limited.

I regard this as an important part of the proposal. Outside influences that distract the Board members from their supervisory responsibilities should be minimized. That includes the influences of such things as bankers' associations, monetary policy considerations and pressures from the executive branch. Hopefully, the Board would enjoy an independence similar to what the Federal Reserve Board has had.

In line with this call for independence of the new agency, I would want it to be self-supporting. This could be made possible mostly through deposit insurance receipts and partly by examining fees.

An additional stipulation designed to insure the Board's independence would require the President to replace a retiring chairman from the remaining four members, instead of allowing him to name as chairman the new member he appoints. This is contrary to Robertson's proposal. He believes the President should have the power to name a new man as Board chairman corresponding to the President's term, as an effort to facilitate coordination between the two offices.

However, I see an unnecessary conflict of interest potential. For one thing, cooperation between the two offices isn't really too vital. But most important, the President has monetary and fiscal policy discretion and might be tempted to use his bank supervisory influence to effectuate those policies.

The Federal Banking Corporation, as described, should largely eliminate the seven main supervisory problems discussed in this paper.

For example, with just one federal agency, the development of uniform supervision and examination policies would be greatly facilitated, if not assured.

Having a five-man Board overlooking 94 per cent of the nation's banks is much more likely to provide a generally accepted concept of the purpose of bank supervision, well removed from either extreme whether it be liberal or conservative.

Merely the combining of three regional offices into one provides a reduction in total supervising costs and very likely other cost savings and efficiencies would accompany the Federal Banking Corporation.

Competitive inequities that are a result of the present structure of federal regulation would disappear with the overlapping statutory responsibilities. So also would the variety of interpretations of federal legislation with which banks must comply.

And finally, the formation of the Federal Banking Corporation and the correspondent lifting of supervisory and regulatory duties from the Federal Reserve System would remove a potential conflict and would enable the Fed to concentrate more on monetary policy considerations.

These points are all just as likely to occur under the Robertson proposal. However, one provision not in his plan that I would include, is an emphasis on formal communication between bankers and the Board.

Robertson felt the relationship between bankers and the three agencies had been good in the past and did not need a provision for formal communication.

Even so, I feel this is no guarantee that it would always be so. The banking industry, like any industry in our dynamic economy, is constantly changing, thus making it important for both parties to understand evolving situations.

It is my belief a bank supervisory structure along the general lines of what I've proposed would eliminate many of the problems now hampering the system. In addition, it is likely such a structure would be of more value in perpetuating the dual banking system than today's three-boss structure.

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A STUDY OF PROBLEMS AND ALTERNATIVES IN THE FEDERAL SYSTEM OF BANK SUPERVISION

by

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AN ABSTRACT OF A MASTER'S REPORT

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The present federal system of bank supervision, consisting of three agencies--the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Comptroller of the Currency--has built-in conflicts and inefficiencies that have drawn a great deal of criticism over the years.

The criticism has come from a variety of sources, including newspapers, periodicals, banking authorities, members of Congress and even the President. All have advocated some form of change in federal bank supervision.

The purpose of this paper is to examine the criticisms, discuss proposed improvements and decide what, if any changes should be made.

The banking industry has been involved in economic calamities that men have tried to prevent from recurring by establishing regulatory agencies.

The three federal regulators were formed separately, each designed to alleviate a specific problem of its time. As a result of this piecemeal development of federal supervision, there is overlapping of jurisdictions, authority and duties.

In an attempt to ease problems resulting from this overlapping, the agencies have reached various agreements, such as allocating primary examining responsibilities for each type of bank, accepting each others examination reports, and adopting a uniform report form. In addition, they also reached agreement on some uniform examination policies.

Despite these efforts, critics still find fault with the present system. Seven different problems commonly mentioned are:

1. Promoting the development of uniform supervision and examination policies is hampered;
2. The different agencies have been guided by different concepts of the purpose of bank supervision;
3. Three agencies entail greater expense in the regulation of banks than is probably necessary;
4. The present system has some inefficiencies in bank supervision;
5. There is the potential for a competition of regulation laxity when three agencies have overlapping statutory responsibilities;
6. Federal legislation affecting the banking area has been interpreted differently by the different agencies thus thwarting much of the desired effect; and,
7. The present system requires the Board of Governors of the Federal Reserve to split its time between such things as monetary policy considerations and bank supervision, both full-time jobs.

In general, there are only two types of proposals for improvement of the federal bank supervision. One advocates maintaining today's three-way structure, but making changes designed to eliminate the present conflicts. The other calls for consolidation of the supervisory functions of the three agencies into one. There are varieties of each of these two types.

Despite the proposed faults and suggested improvements of the present system of federal bank supervision, there are many defenders of the status quo. They believe a structural change of the consolidation type would destroy the dual banking system, among other things.

However, this report contends the federal regulatory problems are serious enough that improvements are needed, and merely seeking better coordination of the three agencies is of no value as a long range solution.

Instead, the powers and duties of the three should be placed in a Federal Banking Corporation, giving the industry one boss rather than three.

Research for this study was conducted predominantly in the main library of the Kansas City, Missouri, Public Library system and in the Research Library of the Federal Reserve Bank of Kansas City.