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

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B.S., Rockhurst College, 1967

A MASTER'S REPORT

submitted in partial fulfillment of the

requirements for the degree

MASTER OF SCIENCE

College of Commerce

KANSAS STATE UNIVERSITY
Manhattan, Kansas

1969

Approved by:

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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_.