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*State and
Federal
Regulation
of
Banking*

*A Roundtable
Discussion*



**Advisory Commission on
Intergovernmental Relations**

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Preface and Acknowledgments |

Legislation introduced, but not enacted, during the 100th Congress would have substantially preempted state regulatory authority over state banks in the fields of insurance and securities. The Federal Reserve Board was also considering similar preemptive rules, including bank-related real estate activities. It is expected that similar legislation and regulatory activity will be considered during the 101st Congress and under the new administration.

Because ACIR was in the process of developing a two-part report on state regulation and taxation of banking, the Commission convened a roundtable discussion on bank regulation at its June 17, 1988, meeting in Bismarck, North Dakota. This report is an edited transcript of those proceedings.

At the conclusion of the roundtable, the Commission considered a report on bank regulation, and recommended that Congress not enact legislation that would further preempt state powers by restricting state regulatory authority over the insurance and securities activities of state-chartered banks. The Commission said that: "Congressional restraint in preempting state [banking regulation] authority has given states opportunities to experiment, innovate, and tailor banking regulation to state and local needs. In turn, there have been many instances where the federal government has adopted regulatory innovations developed by states."

Many states are experimenting with regulatory innovations and are granting powers to state banks that allow them to offer new products and services, such as securities and insurance brokerage and underwriting. These states believe that granting banks the power to offer new products and services can benefit not only the banking industry through greater efficiency and diversity but also consumers through increased competition and more accessible services, and businesses through improved access to capital markets.

In making its recommendation, the Commission found that "the nation's dual banking system has many benefits for citizens, states, and local communities. . . . Many state regulators have used their authority responsibly in extending new powers pertaining to insurance, real estate, and securities to their state banks." The Commission noted further that the balance that has been struck by Congress to date gives due regard for the rights of the states and the protection of the federal deposit insurance fund.

The full findings and recommendation of the Commission can be found in ACIR's publication *State Regulation of Banks in an Era of Deregulation* (A-110).

The report also contains chapters on the historical context of bank regulation, current issues in bank regulation, and proposed federal preemption activity.

The Commission would like to thank the participants in the roundtable discussion for their excellent presentations: Sandra B. McCray (author of the ACIR report), James Chessen of the American Bankers Association, David Halvorson of the New York State Banking Department, Kathleen O'Day of the Federal Reserve Board, and Keith Scarborough of the Independent Bankers' Association. The proceedings of the discussion were edited for publication by ACIR Director of Communications Robert Gleason.

John Kincaid
Executive Director

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The Dual Banking System: Evolution and Current Status

Sandra B. McCray

The dual banking system—by which both state governments and the federal government charter and supervise banks—has a long history. Prior to 1864, state-chartered banks dominated banking in the U.S. The dual banking system began in 1864 with the passage of the *National Currency Act*. That act created a national banking system. After 1864, then, national banks, chartered by federal authorities, existed side by side with state-chartered banks.

Three features of the dual banking system are worth particular attention, both from an historical perspective and as a measure of the system's current vitality: (1) state and federal regulatory competition, (2) multiple regulation of banks, and (3) congressional preemption of state power to regulate and supervise state banks.

Regulatory competition between national and state-chartered banks has been a part of the dual banking system since its birth in 1864. The *National Bank Act*, which was the successor to the *National Currency Act*, was based on the earlier New York State Free Banking Act. Both the New York State and federal acts required banks to keep a portion of their capital in securities on deposit with their respective regulators, and both acts limited the powers of their banks, but the specific requirements differed. For example, national banks had to deposit only federal securities while New York State banks were not so restricted in the kinds of securities that they could deposit. Also, national banks could only extend commercial credit while state banks were allowed to make mortgage loans.

The effect of these differences was predictable. From 1864 to 1900, many national banks converted to state charters in order to participate in the greater lending powers of state banks and the fewer restrictions on reserves. The Congress responded in 1913 by authorizing national banks to participate in real estate lending. This was the beginning of the federal/state regulatory competition that continues today. Typically, the Comptroller of the Currency (OCC), who regulates national banks, will grant new powers to national banks, and state regulators will respond by granting similar powers to state banks and vice versa.

Many have questioned the value of regulatory competition. Some commentators praise regulatory competition as preventing stagnation and encouraging innovation. Others have condemned it as creating a competition in laxity. Those who condemn the regulatory competition extol the benefits of

centralization and uniformity of regulation. There is no doubt that centralization and uniformity would bring some real benefits to the U.S. banking system, including relief from conflicting and duplicative rules, and consistency and order to a system that is now so interconnected as to be truly nationwide, if not international. Yet, there is another, less praiseworthy side to centralization and uniformity. Centralization and uniformity can lead to rigidity, which delays innovation. For example, centralization and uniformity tend to make the introduction of new products, services, and methods of delivery deviant behavior, and therefore act as a constraint on innovation.

If centralization and uniformity stifle innovation, however, we must ask whether the current decentralized and nonuniform system has fostered innovation. The answer must be a resounding yes. Virtually all commentators agree that the dual banking system has promoted competition among state and national banks, and, in doing so, has changed the way that banking is being conducted. Many of the changes in banking have begun at the state level. On numerous occasions, prior state experiments have provided models for federal bank legislation, including the *National Bank Act*, the establishment of the Federal Deposit Insurance Corporation (FDIC), the use of checks, the federal provisions for bank examinations, and the payment of interest on checking accounts. The promotion of innovation is considered, therefore, a significant benefit of the dual banking system.

Multiple regulation and supervision of banks, and congressional preemption of state powers to regulate and supervise banks are really two sides of the same coin. The history of banking reveals an industry that over the years has faced many bank panics and crises. Increased federal regulation followed many of these bank crises. Both the Federal Reserve System and the FDIC grew out of bank crises. In adding these layers of federal regulation, however, the Congress has carefully refrained from preempting states' rights as primary regulators and supervisors of their state-chartered banks.

For example, the *Federal Reserve Act* made state bank membership in the Federal Reserve System optional. By choosing not to become members of the system, state banks could escape regulation by the Federal Reserve Board. About 90 percent of state-chartered banks have chosen not to be members of the Federal Reserve System. The 1933 *Glass-Steagall Act*, which prohibits banks from engaging in securities underwriting, also excludes from its prohibitions state banks that are not members of the Federal Reserve System. Therefore, most state-chartered banks are not forbidden by federal law from engaging in securities activities. Although state-chartered banks are not subject to the regulatory power of the Federal Reserve Board unless they voluntarily choose to become members, all state-chartered banks that are not members of the Federal Reserve System are subject to some regulation by the FDIC. In return for federal insurance of their deposits, state banks must submit to regulation by the FDIC. The FDIC's regulatory control has grown significantly since the creation of that agency in 1933. For example, all bank mergers resulting in creation of an insured state nonmember bank and all new branches of insured nonmember banks must be approved by the FDIC. Also, an FDIC rule requires that securities activities of insured nonmember banks be carried on in a bank subsidiary rather than in the bank itself. The present shared state/federal regulation of banks has created four regulatory categories: (1) state member banks, which are regulated by states and the Federal

Reserve Board; (2) state nonmember banks, which are regulated by states and the FDIC; (3) national banks, which are regulated by the OCC and the Federal Reserve Board; and (4) bank holding companies that are regulated by the board and some states.

States are continuing to perform their historic mission as laboratories for experiments. States are continuing to innovate and to tailor their banking systems to their own particular needs. Interstate banking is here; regional reciprocal information sharing and bank examination coordination among states is working well; some states are experimenting with creating regulatory parity among true banks and bank-like entities; and other states are experimenting with granting their state-chartered banks new powers, such as insurance and securities brokerage and underwriting, and real estate investment and development.

Problems exist, of course. Not all state departments of banking are equally well run and well staffed. Not all state legislatures and regulators are as careful as they should be in requiring safeguards prior to allowing state banks to engage in new activities. A federal check exists, however, in the form of FDIC regulations concerning new state bank powers. In this manner, the Congress has struck a balance in our federal system: one that gives due regard for the rights of states and for the protection of the federal insurance fund. Pending congressional legislation, which will be described by commentators from the Federal Reserve Board, the Independent Bankers Association, the American Bankers Association, and the New York State Banking Department would upset the balance by broadly preempting state regulatory authority over state-chartered banks.

The Dual Banking System: Sound and Consistent Regulation

Kathleen O'Day

From the point of view of the Federal Reserve Board, dealing in securities, insurance, and real estate are not strictly banking activities. They are historically different from banking and present different risks. The conduct of such activities by banks raises questions of substantial federal interest, primarily for three reasons: (1) the implications for the continued health of the financial system as a whole; (2) the potential threat to the federal deposit insurance scheme; and (3) the potential advantage gained by a federally insured bank that conducts these activities through the implied support of the federal safety net available to banks.

Major initiatives are under way in the areas of securities, insurance, and real estate that are not necessarily inconsistent with the continued viability of the dual banking system.

The United States Senate recently passed, by a 94-to-2 vote, the "Financial Modernization Act of 1988," the so-called Proxmire-Garn bill. The major purpose of the legislation is to strengthen competition within the financial services industry under a sound and consistent regulatory framework. The bill proposes to do this by repealing the half-century-old legislation known as the *Glass-Steagall Act*, which separates commercial banking from investment banking.

Glass-Steagall was passed in response to the financial crises of the 1930s. It was believed at the time that the stock market crash and the subsequent failures of thousands of banks were caused in large part by fraud and other abuses by the securities affiliates of banks. As a result of the *Glass-Steagall Act*, commercial banks were prohibited from engaging in most securities activities. They were prohibited from becoming affiliated with securities companies and from having any kind of officer or director interlocks with securities companies.

These barriers remained more or less effective for over three decades, but in the last 20 years rapid technological advances and financial innovations by all kinds of financial services participants increased to the point that the commercial and investment banking industries were placed in substantial competition with each other for the same customers. Especially in the last 10 to 15 years, there have been attempts by securities companies to enter banking, and vice versa. They have done this through exploitation of various loopholes in the *Glass-Steagall Act*, and in other federal bank regulations.

A major avenue by which large investment banks entered commercial banking was the acquisition of state-chartered banks. Similarly, state-chartered commercial banks attempted to enter the securities business through the use of state-granted powers. Even those national banks or bank holding companies, subject to federal regulation, sought to exploit inconsistencies and loopholes in federal laws in order to avoid *Glass-Steagall* restrictions. In the opinion of the Federal Reserve Board, the result is that the United States financial services industry is lurching forward in fits and starts, because there is no comprehensive regulatory response to the changing marketplace for financial services.

The Proxmire-Garn bill attempts to establish a comprehensive regulatory framework, in the words of the committee report, to “reflect the realities of today’s marketplace while fashioning a set of proper safeguards to protect the safety and soundness of our financial system.” The bill would allow a bank to become affiliated with a securities company, but only through the mechanism of a bank holding company, that is, the parent company owner of a bank. In other words, the bank could have a securities affiliate, but only as a sister affiliate. The bank could not itself own the securities company.

The Senate report states that the bank holding company structure is necessary to insulate the bank from the securities affiliate in order to prohibit the emergence of conflicts of interest and threats to the financial system.

This insulation is deemed necessary in order to promote impartial credit decisions by the bank, to prevent problems in the securities affiliate from directly affecting the bank—thereby potentially disrupting financial system stability—and to ensure that banks’ securities affiliates do not have an unfair advantage in funding their operations because of their association with a federally insured institution.

The Senate chose the holding company approach as opposed to permitting securities subsidiaries of banks because it deemed that a bank would be strongly tempted to support an ailing securities subsidiary. In such a situation, the bank’s consolidated financial statements would be affected adversely by a problem in the subsidiary securities company. By placing the securities activity in an affiliate that is separate from the bank, the bank’s financial condition would not be directly affected by problems in the affiliate. The Senate also determined that keeping the decisions of the securities subsidiary distinct from the interests of the parent bank would be far more difficult than if the activities were conducted in a separately organized and capitalized subsidiary of the bank holding company.

Not only does the bill require that there be a separate structure for the securities affiliate, it also establishes significant “firewalls” between the bank and the securities affiliate. These are designed to insulate the bank, to preserve its ability to make impartial credit judgments, and some firewall provisions stipulate that a bank cannot lend to its securities affiliate. Under the bill, a bank could not purchase the assets of a securities affiliate. It could not issue guarantees for the affiliate’s benefit. A bank could not lend in order to allow a customer to purchase a security being underwritten by the securities affiliate. Those are examples of some prohibitions; there are many others.

In addition to the separate structure, it was considered necessary to put in place several protections for the bank itself. The Senate determined that these types of firewalls would be more difficult to enforce in a parent/subsidiary relationship. Therefore, the bill does not allow a bank to own a securities affiliate.

To the Federal Reserve Board, establishing and maintaining insulations between the bank and its securities affiliate has obvious advantages. Although securities activities are viewed differently today than in the past, they nevertheless present risks that are substantially different from those encountered in banking. If improperly controlled, these risks can be substantial. To place such risks in a subsidiary of a bank is to make the bank itself subject to that risk. This implicates the significant federal interest in protecting the federal deposit insurance fund. To the extent that a federally insured bank is adversely affected by a subsidiary securities affiliate, the federal insurance fund is threatened.

It is worth noting that the Proxmire-Garn bill would affect only the activities of federally insured banks. If a bank is not federally insured, there is not a federal interest in regulating its securities activities.

The second significant federal interest in regulating the securities activities of banks is that a subsidiary of a bank would likely enjoy a market advantage over nonbank companies in obtaining funding for the operations of the securities affiliate. This advantage stems from the perception in the marketplace of the federal safety net available to banks. The perception is that federal reserve credit and federal deposit insurance work to protect the subsidiaries of banks as well as the banks themselves. As a result, third parties might be more inclined to provide funds to or otherwise do business with a subsidiary of a bank rather than with a securities company that does not have a bank as a parent. This would create a competitive inequality between bank subsidiaries and other types of companies that are engaged in the same types of activities. The requirement of the holding company structure is intended to help avoid this competitive inequality.

By also requiring all securities affiliates to be placed in the holding company structure and be regulated by the Securities and Exchange Commission (not by the Federal Reserve Board), it is intended that all securities companies will be on a level playing field. The Congress was also concerned that if subsidiaries of banks engage in securities activities, various regulators might have a vested interest in attracting more business to their particular turf, and, therefore, might be more inclined to be lenient. The Senate wanted to avoid this competition in laxity with respect to the securities industry.

One of the arguments that is offered against the Proxmire-Garn bill is that permitting states to determine the scope of a bank's securities activities will promote innovations in delivering securities services to the public. Such innovation in the banking area has usually stemmed from banks seeking to avoid a legal barrier to engaging in the business. But under the Proxmire-Garn bill, a bank securities affiliate could engage in any type of securities activities. (One caveat is that until 1991 they cannot underwrite corporate equity securities, but a vote on that matter is scheduled for 1991. Otherwise, they can engage in any type of securities activities, so there would be no barrier to overcome in providing these services.) The innovation in the securities area

would come from open competition with all other securities companies on a level playing field. Therefore, providing for state innovation in securities activities would not seem to be a strong reason for opposing the Proxmire-Garn bill. Indeed, the Federal Reserve Board also believes innovation is a critical element in the evolution of a safe and sound, modern banking system in the United States.

With respect to the insurance activities that state banks would be allowed under the Proxmire-Garn bill, the rights of a free-standing state bank are not affected. In other words, if the state bank is not owned by a bank holding company, the bill does not affect what it can do. Only if the state-chartered bank is owned by bank holding company does the bill restrict the right of the state bank to engage in certain insurance activities. There is an exception, however. A state bank can still engage in insurance activities in the home state of the bank holding company where the state authorizes such activities and the insurance is provided to residents of the state, persons employed in the state, and other persons who have reason to be in the state.

Concerning real estate activities, the Federal Reserve Board has offered a number of proposals that would restrict state bank subsidiaries of bank holding companies. At the heart of these proposals was the issue of whether the board should authorize the activity for the bank holding company and require the bank to move the activity out of the bank and into a holding company subsidiary. The board's concern has been prompted by the action of a number of states to grant state banks the authority to engage in real estate activities to a significant extent, especially real estate development. The reason why the board has considered regulating these activities is that, even more than securities activities, real estate presents substantial risks. Investments in real estate are characterized by variations in economic value. In terms of cash flow, real estate investments are generally illiquid, particularly during periods that involve economic stress in the banking system. Therefore, the same reasons that support placing securities activities in a separate subsidiary of the holding company also support requiring that real estate activities be placed in a bank holding company. These concerns are undoubtedly related to real estate problems encountered by the thrift industry. Real estate problems helped bring about a crisis in the industry that now must be resolved by federal recapitalization of the Federal Savings & Loan Insurance Corporation.

To the extent that the board sees dangers to bank holding companies and their subsidiary banks from the conduct of real estate activities, the board believes it has the authority to require that such activities be moved out of the bank. At the moment, however, the board is merely monitoring the situation. In a letter to Chairman Fernand J. St. Germain of the House Committee on Banking, Finance, and Urban Affairs, Federal Reserve Board Chairman Alan Greenspan indicated that the board would not take any action at this time on the real estate proposal.

The Federal Reserve fully supports the Proxmire-Garn bill relating to securities activities. It is an appropriate federal response to a critical need in the national financial economy. The bill is also supported by the Administration, by the FDIC, the OCC, and the SEC. It is believed to be one of the better vehicles for forward movement in financial services, without threatening the dual banking system. There is still significant room for the states to innovate and to operate in the area of banking itself.

The Dual Banking System: Challenges to Diversity

Keith Scarborough

Banking is a unique industry in the United States. We have more than 14,000 commercial banks across the country, ranging from small banks with several million dollars in assets to the billion dollar money center banks. It is important to keep in mind that this diversity is a real strength of our financial system. No other country in the world has this number and this diversity of banking organizations, and the dual banking system has played a very important role in creating this diversity. Dual banking permits states to be laboratories for change in banking products and services. It encourages local control of financial resources, and it allows the states to create a banking system which best meets their local needs.

Nevertheless, the dual banking system faces a number of challenges. The Independent Bankers Association is strongly opposed to the Proxmire-Garn bill. It definitely preempts state control over state nonmember banks and essentially cuts state legislatures out of the business of authorizing securities powers for their banks. In order to protect safety and soundness, the Federal Deposit Insurance Corporation (FDIC) adopted regulations in 1984 which set up the firewalls and the regulations as to how state banks operate these securities powers.

A recent report from the General Accounting Office outlined various options—bank holding company, bank subsidiary, the various ownership or regulatory ways to operate securities powers—and concluded that, under certain circumstances, there was no greater threat to a bank subsidiary than operating securities activities through a bank holding company. Therefore, the Independent Bankers Association disagrees with the Federal Reserve Board's premise that the only way to conduct securities activities safely is through the bank holding company format.

The Proxmire-Garn bill would preempt state laws and require that if a state bank engages in securities it must do so under a new federal structure, and in most cases through the bank holding company structure. The association is also concerned about the potential for concentration of power and wealth that would result from the Proxmire-Garn bill.

The Proxmire-Garn bill goes even further by allowing a securities firm to also be engaged in insurance, travel agencies, and other kind of financial activities. Allowing these kinds of combinations of various financial activities compounds the concerns about concentrations of power and wealth.

The Independent Bankers Association hopes that the House won't follow the Senate approach. There have been several bills introduced in the House that would provide new securities powers to banks without all of the negatives of the Proxmire-Garn bill. These bills don't repeal the *Glass-Steagall Act*, but they amend the *Bank Holding Company Act* or the *National Bank Act*. These bills do not preempt the power of states over their state nonmember banks, and they provide for more competition rather than more concentration in the marketplace.

Turning briefly to the area of real estate, besides the Federal Reserve's proposal, there are a number of other proposals pending in the Congress, ranging from requiring all real estate activities to be conducted in a bank holding company to some kind of reinstatement of a moratorium whereby federal agencies or state governments would be prohibited from approving any new real estate powers for banks.

Currently there are 24 states that have some kind of state authority for real estate. Some allow development, some just brokerage. State laws that are in place need to be protected, while at the same time providing some new authority for national banks in the area of real estate.

The dual banking system faces two other challenges. The first is an effort on the part of the Comptroller of the Currency (OCC)—the primary regulator of national banks—to overturn state laws relating to branch banking. The problem began in Mississippi in 1987, when the OCC authorized a national bank called Deposit Guaranty to open a branch in an area more than 100 miles from the main bank. Under Mississippi law, savings and loans can branch statewide, but commercial bank branches must be within 100 miles of the main bank. But the Comptroller allowed this bank to establish a branch beyond that 100-mile limit in violation of state law.

In order to approve this application, the OCC went through a very convoluted interpretation of the *McFadden Act*—the federal law which regulates branching by national banks. Essentially, *McFadden* provides that a national bank can establish branches in a state in the same way and to the same extent that state banks can operate branches.

Yet, in approving this application, the Comptroller ignored *McFadden*, instead doing a functional evaluation of the kinds of activities permitted to thrifts and commercial banks by Mississippi law. Because thrifts in that state have many of the same powers as commercial banks—commercial loans, checking accounts—the OCC found that banks and thrifts are pretty much the same in Mississippi. Since thrifts can branch statewide, the Comptroller determined, national banks should also be allowed to branch statewide.

The Mississippi banking commissioner appealed the decision, but the state lost in the lower courts, and the U.S. Supreme Court recently refused to hear the appeal. With this victory in hand, the Comptroller is now surveying the country for other states where the thrifts have broader branching rights than national banks or state banks, and has already approved three other applications under this similar theory. The effect is to allow national banks to branch to a much greater extent than state banks.

This situation raises a very fundamental states' rights issue. Can the Comptroller of the Currency permit greater branching rights for national

banks than state law permits for state banks? If so, it undermines the dual banking system and the whole purpose of the state efforts to control the branching issue.

Another significant challenge facing the dual banking system is in the area of deposit insurance. The Federal Savings and Loan Insurance Corporation (FSLIC), which insures savings and loans, is in a severe crisis. There are hundreds of bankrupt, insolvent thrifts around the country that are still open, that are still taking deposits, simply because the FSLIC doesn't have the resources to close them down. Various estimates of the cost of rectifying this situation range from \$20 billion to \$60 billion. Last year Congress passed a \$10 billion recapitalization bill for the FSLIC. The \$10 billion is not taxpayer dollars; rather, it will be raised by a bond system that was established in the bill. The consensus in Washington seems to be that this \$10 billion will be enough to keep the FSLIC operating at least through the end of the year. Obviously, one of the first banking issues that the new Congress and the new Administration will have to address next year is a long-term solution to the thrift crisis. The two major alternatives that are being discussed are either a taxpayer bailout or some kind of merger of the FSLIC with the FDIC. The banking organizations are not very excited about either of those alternatives.

How does this problem with the thrift crisis affect the dual banking system? Congress is going to look very closely at the powers that the states have granted to their banks and their thrifts and at how these state powers affect the deposit insurance system.

Several weeks ago, Sen. Don Riegle of the Senate Committee on Banking, Housing, and Urban Affairs Committee asked the following question of FDIC Chairman Bill Seidman:

Why should the federal government put federal deposit insurance under any activity that is not authorized by the federal government, whether it is a savings and loan system or any other system? Why should we allow states to stretch out the activities if the taxpayer is going to be on the hook for this in the end?

Congress is also going to be looking very carefully at the ability of the states to regulate effectively the banks and the thrifts that they charter. Just last week, the FSLIC paid out over \$1 billion to depositors in order to close a single insolvent state thrift in California. Obviously, the FSLIC fund cannot afford many more of these payouts. There is going to be a very close scrutiny of state powers and of the effectiveness of state regulation of banks and thrifts.

The last ten years have seen tremendous changes in the financial services industry. In earlier times, people banked with their hometown banker and bought insurance from the local insurance agent, and when people went to Sears they bought shoes or tires or underwear, not insurance or securities or bank products. But in these days of deregulation all those traditional lines have broken down.

Despite these pressures, the Independent Bankers Association is confident about the ability of community banks to compete. They still serve a very important purpose in the financial services industry. So the association is working hard in the Congress to protect the rights of state banks and community banks, whether state or national, across the country.

*The Dual Banking System:
Expanding Roles in the Financial System*

James Chessen

Banking organizations play a very important role in the financial system and in the overall economy. However, outdated laws prevent innovative banking organizations from creating new products and services to meet customer needs. For this reason, customers are looking to other providers for these services. There are trends developing with important consequences that deserve attention.

For example, shares of the prime commercial credit market—a traditional and basic banking function—has declined precipitously for large banks since the mid-1970s, and today commercial lending at large banks accounts for only about half of the short-term credit of domestic nonfinancial corporations. Much of this share has been lost to the commercial paper market. Banks are prohibited by current law from participating in that market.

Foreign banks also have made significant inroads in the domestic commercial and industrial loan market. In addition to lower regulatory standards, many foreign banks have broader product and service authority in their domestic markets than American banks do here. These additional lines give foreign banks a more diversified earnings base, which they can use to strengthen their own capital positions.

Auto loans are an additional lending market in which banks have faced increasing competition, primarily from finance company subsidiaries of auto manufacturers.

Another recent development in the bank lending markets is the trend toward securitization. Advances in information technology and reductions in costs have shifted the cost advantage away from banks and toward securities markets. The growth of mortgage-backed securities is a prime example of this, and the trend toward securitization is moving into other areas, such as automobile loans and consumer receivables.

In sum, the basic nature of many of the important bank lending markets is changing. And while the traditional markets are shrinking for banks, they are precluded by law and regulation from participating in these emerging markets, either directly or through affiliates.

For banking organizations to remain a healthy and vital part of our financial system, they must be allowed to offer an expanded list of products and services, including the authority to engage in securities, real estate, and insurance activities. The resulting diversification of income would reduce risk and

help to strengthen banking's capital base—two major factors that would ensure the long-term safety and soundness of the industry.

Unlike the Independent Bankers Association, the American Bankers Association (ABA) has supported the Proxmire-Garn bill. We believe that it would expand bank securities activities, enabling them to compete more fully with nonbank financial institutions that have increasingly offered bank-like services. While the ABA supports the bill, it is not happy with every aspect of it, particularly areas where state law is preempted unnecessarily.

ABA agrees with the Independent Bankers Association that securities can be insulated from banking activities within a bank to the same degree as separating the activity in a separate subsidiary of the holding company. Regardless of the arguments on either side, however, the political realities suggest that the only way we will get expanded powers is through the holding company mechanism. The White House and the Treasury have made that clear.

On the issue of insurance activities, states have had a long tradition of regulation in this area, and we believe the legislative compromise contained in the Senate bill is flawed. Allowing the banking industry to participate fully in insurance agency brokerage and underwriting would lead to lower costs, additional information, greater convenience, and more choices for users of these services. These benefits would accrue to an even greater extent if the insurance industry's anticompetitive exemption from antitrust laws were eliminated. Full insurance products and services for banking would diversify banks' income, decrease their risk, and increase capital for the industry. Again, these changes would help keep banking safe and sound and the financial system and the overall economy strong.

There is a long tradition of bank involvement in insurance activities pursuant to state legislation, from the savings banks in New York and New England that sell savings bank life insurance to the several states in the upper Midwest that have permitted banks to own insurance agencies for decades.

Recently, state action in this area seems to be accelerating in favor of allowing banks more insurance activities. Recently, state actions indicate a willingness to give banks more leeway in insurance activities. For example, in 1987 Oregon enacted broad legislation permitting all state banks and state-chartered bank holding companies to sell virtually all types of insurance products. Illinois is also considering changes in its laws, and in California a broad insurance reform initiative is on the statewide ballot in November.

This broad tradition and the recent upsurge of state action must be kept in mind when discussing the Proxmire-Garn bill. As the year began, it was clear that the insurance industry would attempt to use the occasion of congressional action to roll back the *Glass-Steagall Act* separation of commercial and investment banking as a vehicle to pare back the existing federal authority for banks to engage in insurance activities.

Perhaps more important, it was also clear that insurers sought a regressive, anticonsumer, and anticompetitive federal preemption of state authority to allow state banks to engage in new insurance powers. The insurance industry was largely successful in respect to the federal authority portion of its agenda. There is nothing in the Senate bill which in any way expands federal

authorization of a bank entering into insurance. In fact, quite the opposite is true. The Proxmire-Garn bill reduces authority for national banks located in small towns to engage in insurance sales and prohibits national banks from selling variable annuities and title insurance.

Fortunately, from our perspective, the Senate rejected any further preemption of state authority in this area. The Proxmire-Garn bill does provide that a state bank subsidiary of a bank holding company may provide insurance as a principal agent or broker if the state has authorized such activities. Furthermore, these activities must be directed to state residents and people who would otherwise be considered to be part of that state.

Finally, the bank must be located in the same state in which its parent holding company is headquartered. While the ABA applauds the Senate for rejecting the insurance industry's attempt to preempt state rights in this area, the association has serious concerns about the third part of the test of permissibility: the requirement that a state-chartered bank be located in the same state as its parent holding company to take advantage of these insurance powers. This was an unnecessary and illogical preemption of state authority that would have the perverse effect of reducing competition as interstate banking continues to develop under state-enacted law.

What this means is that if a state chooses to authorize broader insurance activities for state banks consistent with the economic well-being of the state, banks acquired on an interstate basis under the state's law would not be able to exercise the new insurance powers. This would put them at a competitive disadvantage with other banks in that state. Even worse, if there was a free-standing bank or a bank controlled by an in-state holding company and that bank was subsequently acquired by an out-of-state holding company, the bank would have to divest any insurance activities. This would deprive the bank's customers of their chosen source of insurance.

On real estate activities the Senate bill is silent, although the Federal Reserve has in the past attempted to assert its authority over state banks and bank holding companies. The ABA strongly opposes the board's imposing any restrictions under current regulations on the subsidiaries of state banks that happen to be subsidiaries of bank holding companies. We believe the Federal Reserve proposals ignore the intent of the Congress, are beyond the board's statutory authority, and violate the Administration's policies.

In conclusion, the ABA feels that expanded opportunities for banking organizations in securities, insurance, and real estate are desperately needed, that they will improve overall competitiveness, and be of substantial consumer benefits to the average citizen. The ABA also believes that banks should have the same option as all other financial providers as a matter of fundamental fairness.

*The Dual Banking System:
Regulatory Competition and
Public Benefits*

David Halvorson

As a state regulator, I would like to share with you some of the evidence I have that the dual banking system fosters not only regulatory competition but also public benefits. There have been ominous trends on this issue in Washington over the last 18 months, trends in which Washington is casually allowing the prerogative of the states to be preempted.

The fundamental issue discussed here is reforming the banking system. There has been a series of fits and starts in Washington over the years which has perhaps not been in the best interest of the industry and consumers. The track record of the states is much better.

Innovation is the hallmark of state-chartered banks.

Do you have a checking account that pays interest? That is a state innovation. It began in New England with NOW accounts. New Hampshire was very active in promoting that more than a decade ago. This was probably the single most important change in banking regulation in the last 15 years, and its ramifications are still felt today.

Do you have complaints about the holds that banks put on deposits of checks, be they government checks, insurance checks, or dividend checks? In 1983, New York State adopted a system and a policy of expediting funds availability that required the New York State Banking Department to sit down with the banks and work out a system to provide for prompt clearing of checks and at the same time preserve the safety of banks. Last year the Congress adopted that model on a nationwide basis.

Do you have a credit card or a car loan or a personal loan from a bank outside your state? Interstate banking is another example of the states responding to the failure of Washington to provide leadership. Not all wisdom flows from Washington, and it has been the states, through regional compacts, that have led this development. In 1983, New York adopted a reciprocal interstate program. It wasn't the one that was the winner in the marketplace. The regional compacts in the Southeast and the Northeast proved to be a more successful approach. Nevertheless, by 1991 interstate banking will be essentially in place throughout the country.

And speaking of credit cards, are you confused about the charges and the interest rates and why it is that you can't find a card that offers you a better deal? New York, in 1987, as part of the extensive deregulation of interest rate legislation, worked out a compromise on disclosure of credit card interest

rates, annual fees, holding periods, and transaction charges. The Congress later adopted that on the federal level.

These are just a few current examples of where the competition between the states and the federal government provides benefits to consumers. You have heard a lot about benefits to banks and regulators, but there are other people in the equation.

New York has licensed branches of foreign banks since 1962. The Congress got around to it in 1978 with the *International Banking Act*.

In 1979, New York mandated truth in savings disclosure. Recently, comparable bills have passed in both the House and the Senate.

Since 1979, New York has disclosed publicly the regulator's evaluation of banks' community service performance. That is part of the debate in the House on the Proxmire-Garn bill.

Beginning last year with proposed legislation driven by the need to sort out the problems of the FSLIC and the S&L industry, the Congress adopted a wait-and-see attitude. They called it a moratorium, but within the dual banking system the moratorium was nothing other than preemption. Since institutions wishing to expand by acquisition or investment or new activity must seek the approval of both their state regulators and a federal regulator, the Congress, by suggesting that the federal regulators could not move forward in the areas of real estate, securities, and insurance, essentially clamped down on innovation at the state level.

In the areas of securities, insurance, and real estate, state regulators have had a good deal of experience in regulation and monitoring. Securities underwriting is permitted in 15 states, securities brokerage activities in another 10 states, insurance underwriting in 5 states, insurance brokerage in 11 states, and real estate development in 24 states.

What are the public policy arguments for denying states a role in this area?

Broadly speaking, they are the health of the banking system as a whole, the vitality of the FDIC, and a perceived market advantage to a bank affiliate or subsidiary that would be engaged in some of these activities.

I would disagree with these contentions. The FDIC leadership has indicated that they believe the insurance fund can be safeguarded and that securities activities can be safely conducted in subsidiaries—that the so-called firewalls can be put in place.

New York has a mini-Glass-Steagall, patterned after the federal law. Based on our experience, regulation of securities activities can be done safely and soundly. It can be done to the benefit of a large number of the smaller banks that cannot, or do not want to, absorb the cost and administrative problems of setting up a holding company and a holding company affiliate.

Secondly, New York regulates 13 foreign banks which are permitted to engage in both securities activities and banking activities in the United States. We have had no problems with that regulatory experience. We have not seen any violations of the existing rules designed to prevent the securities activity from affecting the capital integrity of the bank. Also, in the four years since the FDIC has permitted its insured institutions to engage in securities activities, a number of our savings banks have done so. Primarily, they have gotten

into the mutual fund area. Their customers want it. We have examined that for four years. We have not seen a problem with it.

It is for these reasons that we think an argument can and should be made for providing flexibility within the federal system for states to have their banks or bank subsidiaries engage in securities activities.

On insurance, New York had problems with savings bank life insurance, an area in which the federal moratorium has required banking institutions which have offered SBLI for 50 years to cease merely because of expansion in the form of acquisitions. We think strongly that the banking bill as it came out of the Senate should be rethought in this area. This is and will continue to be an environment of a great deal of interstate banking acquisitions. What it would do essentially for those 20-odd states that allow their banks to sell or underwrite insurance over time is restrict that authority because there would be relatively few banks left operating solely within one state.

The Congress should rethink the absolute prohibition on securities activities being granted by states. The insurance issue should be revisited. This gets to the heart of the federalism issue in areas of banking which are entwined in state and federal issues.

The Discussion |

Sununu: Can you talk a little bit more about the current and perhaps future involvement of foreign banks in the acquisition process in this country? How do the different characters of the state banks versus the federally chartered banks fit in? Do we have some unfinished business at the state level that we ought to address because of new trends?

O'Day: I will address that because there is a comprehensive federal scheme in place with respect to foreign banks. Any foreign bank that chooses to acquire a bank in the United States, whether it is state chartered or federally chartered, must apply to the Federal Reserve Board for approval.

Once it acquires the American bank, the foreign bank may conduct activities according to the American bank charter and according to whatever ultimately comes out of all this rethinking of federal legislation.

But one issue that is of concern with respect to these foreign acquisitions is that some foreign banks have been operating with less capital than is required for American banks. This puts American bank holding companies at a competitive disadvantage, because they then have increased costs in raising capital and in conducting their operations.

This is being addressed on an international basis through a Conference on Central Bank Supervision. The conference is attempting to establish international capital standards for all international banking organizations.

Sununu: If states adopted a capital requirement for acquisitions, would it be respected as a requirement under the analysis performed by the Federal Reserve in permitting or not permitting the acquisition?

Halvorson: It probably has not been resolved. If I am not mistaken, the Federal Reserve Board has taken the position with respect to subsidiaries of foreign banks that the ability to get into that United States business would require additional capital to be raised by the foreign bank. I applaud the Federal Reserve for doing this, because it is a prod in the process of getting cooperation on capital at the international level.

On the examination side, there is the Basel Concordat, an agreement that for banks operating in many countries, the primary regulator, the home country regulator, will have primary jurisdiction over activities worldwide, but in cooperation with the host country regulator.

Sununu: Is there an ongoing structure internationally in which this kind of review is taking place?

Halvorson: The Cook Commission is referred to. It is also known as the Basel Committee on Banking Regulation and Supervisory Practices, a group of home country bank regulators from the major industrial countries. This country is unique because of diversification of supervisory authority. The Federal Reserve Board, as central banker, has adopted the lead role in this country.

Sununu: Are there state representatives in that structure?

Halvorson: Informally. The problem is in defining an appropriate voice for the states.

Sununu: Let me pursue that. Is it an appropriate thing for us to recommend that a voice representing states be included in that process?

Halvorson: We in New York have taken the position that there should be more involvement by the states.

Sununu: I would be interested in the panel's opinion as to whether the relatively low savings rate that we have in this country is related to the banking structure.

Halvorson: It is a tax issue, and clearly a problem that has to be addressed. Our savings rate is something like 2 percent. The European average savings rate is, I believe, about 4.5 percent. In Japan it is, I believe, about 6 percent. I am not certain that the structure of bank regulation would solve the problem. I think it is an issue of the structure of taxation of personal income and savings.

Sununu: For a long time there were traditional instruments issued by banks that were not very creative. Banks have moved into CDs a little bit more aggressively now, creating smaller denomination certificates, and so on. Are there any regulations or laws that have inhibited creativity in instruments that might be more attractive to the smaller saver?

O'Day: I think most of the inhibitions were removed in 1980 with the *Monetary Control and Deregulation Act*. This allowed banks to offer a much broader range of deposit instruments, mainly to make banks competitive with money market mutual funds.

Sununu: But that removed a set of parallel regulations to allow them to compete in one area. My question is, did it go far enough? Are there other things that we ought to look at?

O'Day: There have been a number of proposals to reduce the cost to banks of maintaining reserves, including whether or not the state should pay interest to banks on their reserves. These proposals have been around for a long time and have never really gone anywhere.

Scarborough: I don't think that there are any more serious regulatory hindrances. In fact, in the last ten years, with the expansion of credit unions and all the changes in the thrifts and banks, there are many more opportunities and fewer restrictions for people to save. Banks are trying creative ways to increase the ability of people to save, and I think it is more a question of tax considerations and personal lifestyles.

Halvorson: There is a role for bank regulators to play in the lifestyle issue. Everyone has heard about the popularity of home equity loans, again driven by

the Tax Code. Bankers often chase a product, and lose their traditional prudence in terms of credit evaluation, and the like. If people think that credit is too easily available, that is a shift in lifestyle that I think bankers and bank regulators, in particular, should respond to.

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