The FBA and the FRB would need to agree on any changes to existing standards (e.g., capital levels) and develop reporting requirements through mutual consultation.

Under the task group proposal, the FBA would determine the permissible activities for all bank holding companies and establish the regulations governing the exercise of such powers. Currently, the FRB exercises unilateral authority in such matters. The FRB would retain the right to disapprove regulations authorized by the FBA that give bank holding companies new powers if a two-thirds majority of the Federal Reserve Board determined that the stability of the U.S. banking system would be impaired.

State-chartered Banks. Federal duplication of state supervisory efforts would be reduced under a new regulatory program. States could seek certification to take over many of the current federal responsibilities for state-chartered institutions by establishing a regulatory program equally reliable to federal regulation. The FRB, FBA, and FDIC would set the criteria for certification. The FRB would act on specific state applications for certification and would oversee the process. Each Reserve Bank would establish a formal State Advisory Council for interaction between the FRB (the sole federal regulator) and the state banking authorities.

FDIC. The FDIC would lose its supervisory responsibilities, operating solely as an independent insurance corporation. The FDIC would have the authority to grant insurance, set risk-related premium levels, revoke insurance, or take other enforcement actions. The FDIC would retain the authority to examine a troubled bank in conjunction with the bank's primary supervisor.

The SEC and the Department of Justice. The regulation of all securities activities of banks and thrifts would be consolidated in the Securities and Exchange Commission (SEC). Currently, the SEC and the depository institutions' regulatory agencies monitor securities activities. The Department of Justice would enforce antitrust laws applicable to banks and thrifts, curtailing the involvement of the financial regulators in antitrust cases.

Conclusion

The task group proposal has not yet been drafted into legislative form. Although the administration is expected to support the proposal, the recommendation could be modified or rejected altogether at any one of several junctures. The financial regulatory system has been the subject of much debate for many years. In past years (1937, 1949, 1961, and 1971), Congress did not act on reports recommending changes to the financial regulatory system. In 1984, however, we are faced with a rapidly changing financial environment. Market forces and technology have altered the financial industry and will continue to spur further deregulation.

Little by little, the financial industry is being deregulated in the same way that it became regulated. Rather than continuing to act on changes in driblets, Congress could control the deregulation process by carefully and thoroughly considering legislation that (1) expands the powers and boundaries of depository institutions and (2) streamlines and strengthens the structure of regulatory agencies. Comprehensive legislation to deregulate depository institutions has been introduced into Congress. The proposal adopted by the Task Group on Regulation of Financial Services complements that legislation by recommending reorganization of the structure of regulatory agencies to meet the demands of the evolving financial marketplace.

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economic commentary

Reorganizing the U.S. Banking Regulatory Structure

by Sandra Pianalto

New financial instruments, new breeds of financial institutions, and different market conditions have developed in the United States since the mid-1970s. The traditional product, geographic, and institutional boundaries of our financial industry have been questioned by advances in technology, inflation, high and varying interest rates, and an increasing demand for more and better services from financially sophisticated consumers. Several pieces of legislation have been enacted to respond to these many changes in the financial marketplace. Two pieces of legislation—the Financial Institutions Regulatory and Interest Rate Control Act and the International Banking Act, both enacted in 1978—placed domestic banks on more equal footing with foreign banks. The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Act of 1982 established procedures to eliminate deposit interest-rate ceilings and gave financial institutions broader product powers. Yet, even with this wide-sweeping deregulatory legislation, many issues in banking structure remain unresolved.

While the goal of financial deregulation is to reduce the barriers to competition and hence create a more efficient marketplace, the safety and soundness of the financial markets are still important considerations in the ongoing process of deregulation. In December 1982 the Reagan administration charged a task group to examine the current regulatory structure and whether it could meet the demands of our evolving financial system. Chaired by Vice President George Bush, with Treasury Secretary Donald Regan as vice chair, on January 31, 1984, the Task Group on Regulation of Financial Services unanimously endorsed a proposal to reorganize the federal agencies that regulate commercial banks.[1]

Reorganization and Regulatory Relief

Banks and other depository institutions perform special functions in our economy. While holding the bulk of America's liquid savings, these institutions also operate the payments mechanism, supply much of the credit used in our economy, and serve as the conduit for monetary policy. The safety and soundness of our depository institutions are necessary to ensure a properly functioning economy. Indeed, the first banking regulations in the United States were enacted in response to bank failures. Repeatedly in the nineteenth century and again in the Great Depression, bank failures caused severe disruptions in our economy. As a result, Congress erected regulatory barriers that prohibited commercial banks from engaging in the risky activities that led to earlier bank failures. Deposit insurance and banking regulations were enacted to instill confidence in banks and to protect the stability of the banking system. However, today's financial system is more sophisticated than the financial system of the 1930s, and yesterday's banking regulations may no longer serve today's needs.

To many observers, the U.S. financial regulatory structure seems to be a hodgepodge of complex rules and procedures, with multiple regulators overlapping in powers and responsibilities. Many regulations resulted from crisis situations and were adopted on a piecemeal basis. Congress is currently considering proposals to change existing bank regulations.

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The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

1. In addition to Vice President Bush and Secretary Regan, the members of the task group included the Attorney General, the director of the Office of Management and Budget, the chairman of the Council of Economic Advisers, the assistant to the president for Policy Development, the Comptroller of the Currency, and the chairmen of the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the National Credit Union Administration.

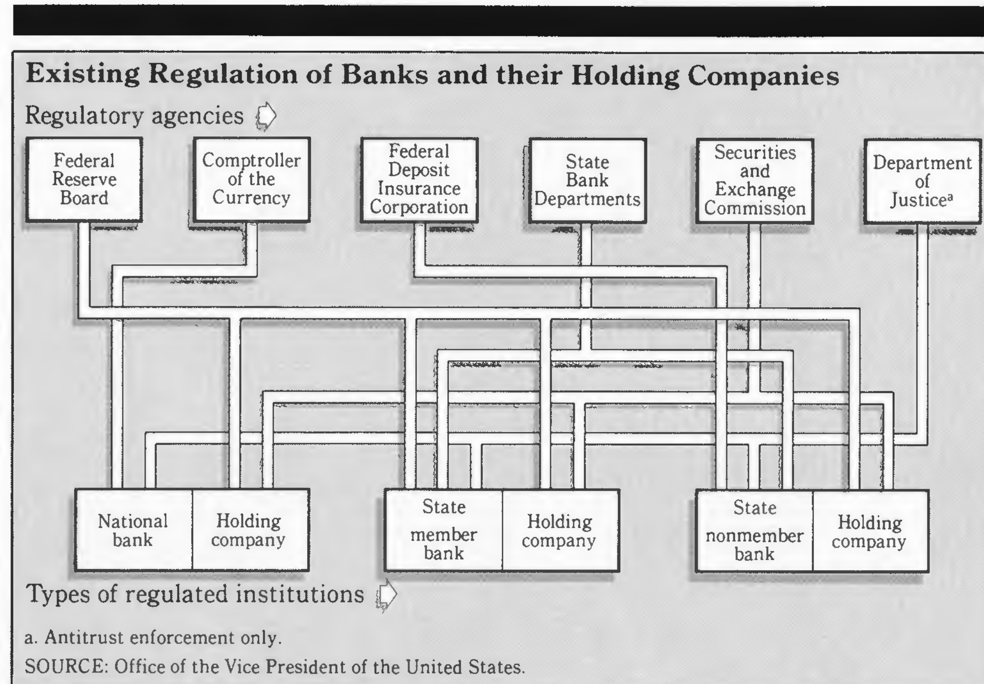
The congressional banking committees are discussing legislation that would allow banks to offer a broader array of financial services.[2]

Many state legislatures are examining legislation not only to expand bank powers but also to relax geographic barriers. Commercial banks and S&Ls have already entered the securities discount brokering business and are now lobbying state legislatures for the authority to enter other business lines and to expand into new geographic markets. South Dakota, for example, has passed legislation that permits its state-chartered institutions to engage in a full range of insurance activities. Fifteen states have enacted some form of interstate banking legislation.[3]

Currently, five federal agencies regulate U.S. depository institutions: three agencies supervise banks, one monitors savings and loan associations (S&Ls), and one regulates federal credit unions.[4] In addition to the federal regulators, agencies in each of the 50 states supervise state-chartered banks and state savings banks, S&Ls, and credit unions. The overlapping powers and divided authorities inherent in this structure often result in jurisdictional disputes and inconsistencies in enforcement, creating further conflict and confusion in an already complicated financial services industry.

Such disarray results in part from regulators trying to apply banking laws established many years ago to institutions operating in a rapidly changing financial environment. Overly restrictive provisions of existing laws, in conjunction with exploitation of loopholes in those laws, have produced conflicts in the regulators' interpretations of those laws. For instance, while the regulator of the lead bank of a bank holding company might consider an activity or expansion permissible, the regulator of the bank holding company itself might interpret the pertinent law differently. To simplify the regulatory system and settle some of the conflicts among regulators, legislation should be passed that expands the powers of depository institutions, spells out the banking powers of nondepository institutions, and defines the term *bank*. Indeed, the task group indicated that its proposed reorganization would complement existing legislation dealing with broadened powers and services for depository institutions and simplification of procedures under the Bank Holding Company Act.

Existing Regulation of Banks and their Holding Companies



a. Antitrust enforcement only.

SOURCE: Office of the Vice President of the United States.

Regulatory Fundamentals

The task group identified four fundamental principles to be incorporated into any reorganization of the regulatory structure. These principles address the concern for safety and soundness, introduce efficiency and flexibility, and provide the regulatory system with the ability to monitor the evolving financial environment.

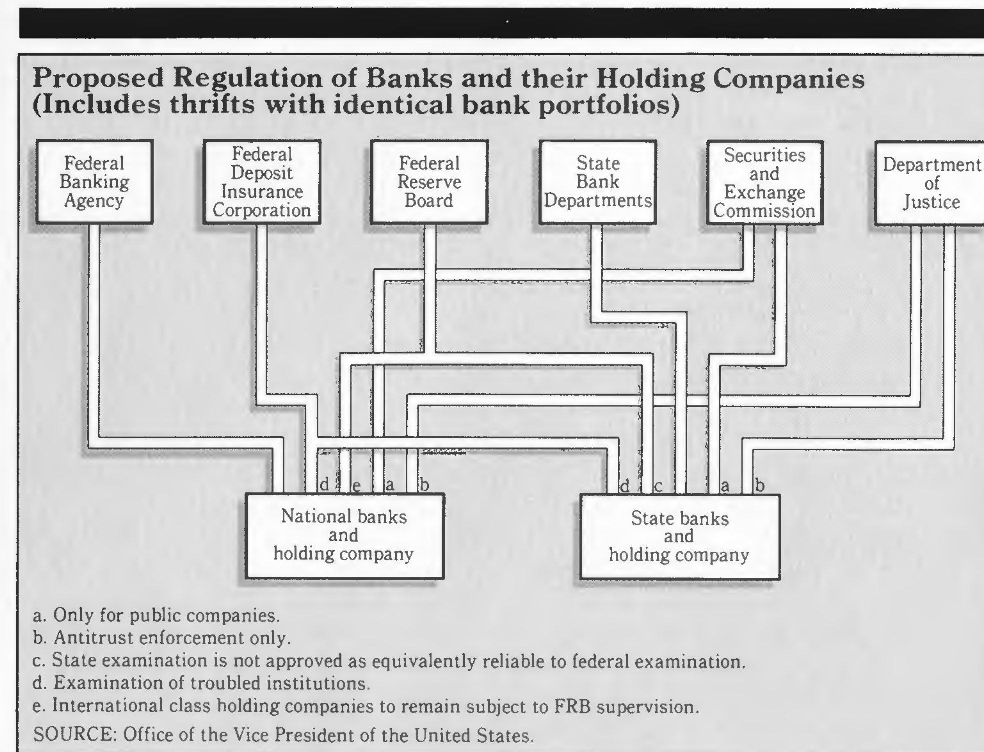
First, the task group recognized the need to *continue the dual banking system*. This is the state/federal banking system, which serves as a system of checks and balances and also allows states to act individually on banking matters and thus test new ideas. Many of the existing national powers and structures were authorized first at the state level. Negotiable order of withdrawal (NOW) accounts, for example, were tested by a few states before being authorized nationwide by the Monetary Control Act. The concept of deposit insurance was tested by more than a half dozen states before the Federal Deposit Insurance Corporation (FDIC) was established 50 years ago.

Second, to *eliminate inconsistencies*, one federal agency should handle the day-to-day regulation of state-chartered banks. Under the current regulatory system, the Federal Reserve Board supervises state-chartered banks that are members of the Federal Reserve System, and the FDIC supervises the federally insured state-chartered banks that are not members of the Federal Reserve System.[5] This divided authority over similar institutions can cause inconsistencies in what are deemed to be permissible activities among state banks. In the past year, for example, the FDIC took a more lenient view of securities activities of state-chartered banks. Such different treatments could give state banks competitive advantages, depending on whether they were regulated by the Federal Reserve or the FDIC.

Third, to *minimize overlapping responsibilities*, regulation of individual banking institutions (i.e., banks and their holding companies) should be integrated under a single federal agency. Currently, the Federal Reserve System regulates all bank holding companies, even those whose subsidiary banks are supervised by the Office of the Comptroller of the Currency (national banks) or by the FDIC (state banks that are not members of the Federal Reserve System).

Finally, the task group recognized that it was of critical importance to *maintain the Federal Reserve System's* meaningful role in the regulatory process. As the nation's central bank, the Federal Reserve is responsible for maintaining the stability of our financial system. To carry out this responsibility, in 1913 the U.S. Congress authorized the Federal Reserve System to operate the nation's payments mechanism, to maintain liquidity in the economy through lending operations at the discount window, and to regulate and supervise key institutions in domestic and international financial markets. These functions complement the Federal Reserve's responsibility for conducting monetary policy. Maintaining a stable and smoothly functioning financial system requires direct and current knowledge of the financial markets, both foreign and domestic. The Federal Reserve acquires such knowledge through its role of assuring compliance with regulations and uses this flow of information to conduct monetary policy.

Proposed Regulation of Banks and their Holding Companies (Includes thrifts with identical bank portfolios)



a. Only for public companies.
b. Antitrust enforcement only.
c. State examination is not approved as equivalently reliable to federal examination.
d. Examination of troubled institutions.
e. International class holding companies to remain subject to FRB supervision.

SOURCE: Office of the Vice President of the United States.

Proposed Changes

The task group has proposed that two federal agencies regulate banks. A new Federal Banking Agency (FBA) would regulate, supervise, and examine all *national* banks; the Federal Reserve Board (FRB) would regulate, supervise, and examine all *state-chartered* banks (member and nonmember). The FBA would be created within the Treasury Department to carry out the current responsibilities of the Office of the Comptroller of the Currency, plus some new responsibilities outlined in the following discussion.

Bank Holding Companies. The FBA would regulate bank holding companies if the lead bank were a national bank; the FRB would regulate holding companies if

(1) the lead bank were a state bank, or

(2) the holding company were in an *international class*, i.e., the holding company

   (a) had a bank with foreign branches or subsidiaries,

   (b) had assets of more than 0.5% of aggregate bank holding company assets, or

   (c) was a foreign-owned holding company.

There are approximately 50 such international class holding companies operating in the United States.

2. Proposals were introduced in the Senate and the House to expand the powers of bank holding companies, streamline the procedures of the Bank Holding Company Act, and clarify the definitions of a bank and a thrift and the scope of powers for state-chartered banks. These proposals are S.1069 and H.R. 3537, the administration's Financial Institutions Deregulation Act; S.2134, the Depository Institutions Holding Company Act Amendments of 1983, introduced by Senator Proxmire, ranking minority member of the Senate Committee on Banking, Housing, and Urban Affairs; and S.2181, the Financial Services Competitive Equity Act, introduced by Senator Garn, chairman of the Senate Committee on Banking, Housing, and Urban Affairs.

3. See Thomas M. Buynak, Gerald H. Anderson, and James J. Balazsy, Jr., "Banking without Interstate Barriers," *Economic Commentary*, Federal Reserve Bank of Cleveland, March 12, 1984.

4. The regulators and their functions are (1) the Comptroller of the Currency (a bureau of the Treasury Department), supervising all national (federally chartered) banks; (2) the Federal Reserve System, supervising state-chartered banks that are members of the Federal Reserve System and bank holding companies; (3) the FDIC, supervising insured state banks that are not members of the Federal Reserve System; (4) the Federal Home Loan Bank Board, regulating federally chartered S&Ls and savings banks; and (5) the National Credit Union Administration, chartering, regulating, and insuring federal and FSLIC-insured state credit unions.

5. State-chartered membership in the Federal Reserve System is voluntary; national banks are required to join the System.