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Issues in Bank Regulation and Supervision

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1. Introduction

The bank regulatory structure that is in place as of January 1994 is the result of the trials and tribulations of the economy and of the monetary and financial system which can be traced at least as far back as the crisis of 1857. Furthermore as the 1857 crisis had its roots some two decades earlier, in the famous struggle between Biddle and Jackson over the rechartering of the 2nd Bank of the United States, we may well say that conflicts over the structure of banking and of bank regulation and supervision take in well nigh the entire history of our republic.

The economic and much of the political history of the United States could well be written as an struggle to get banking and finance right. This struggle is still with us. It may well be a never ending struggle, because there are strong endogenous determined evolutionary tendencies that operate in a capitalist financial system so that what is an apt legislated structure at one time becomes inept as time goes by. (Even though a kiss is still a kiss, what was right in Paris is wrong in Casablanca)

Presumably, getting banking and finance right implies that the payments mechanism is secure and safe and funds for the capital development of the economy are forthcoming at an appropriate rate so that the establishment and maintenance of a close approximation to full employment and an acceptable rate of economic growth is accompanied by a tolerable rate of inflation.

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Experience over the past decade informs us that we still have not got banking and finance right. This note is an endeavor to help us get banking and finance right for our economy by developing an apt structure of supervision and regulation of banks and other financial institutions.

It should come as no surprise that a regulatory structure for banking and finance, which grew by accretion over more more than 150 years, needs an overhaul from time to time: im particular those institutions and usages which are the result of legislation and administrative decisions which are now obsolete need to be weeded out.

The need for claeaning up the landscape is especially acute now. The electronic revolution is changing the national and the global monetary and financial system. A financial system based upon the third millenniums capabilities to communicate and compute promises to differ greatly from the financial systems of 1837, 1863, 1913 and 1935, when the foundations of our regulatory and supervisory structure were laid.[1]

New institutions and instruments, along with changes in the economic significance of inherited institutions and instruments, are an everyday occurance. The regulatory and supervisory structure needs not only to adjust with the institutional and usage changes but also to guide the development of apt financial institutions.

These obvious observations imply that a unified bank and financial system regulatory and supervisory authority may be good thing. This new authority, which will replace the existing complex of authorities, needs to be sensitive to the evolutionary character of our economy and financial structure and to be independent of the particular

1. A potted history would read that
1837 saw the emergence of state chartered banks as the dominent financial structure,
1863 legislation for nationally chartered banks, the elimination of state bank notes and the founding of the office of the Comptroller of the Currency to oversee state banks and the integrety of the currency supply,
1913 the Federal Reserve System and
1930's a reformed Feseral Reserve System, Federal Deposit Insurance and the doctrine of transparency as embodied in the SEC legislation.

interests of the constituent elements of the existing and ever changing banking and financial structure: an authority whose domain is the entire financial structure will not see its role to be the defense of particular vested interests in the financial structure.

For the United States to be the center of the global financial structure into the third millennium the regulatory and supervisory mechanisms of the financial system need to assure both domestic and international holders of assets that the principle of their holdings in the payments mechanism are safe and secure and that the United States provides access to markets of *unquestioned integrity* for the financing of industry and trade and for the adjustment of positions in assets.

In the Jackson - Biddle fracas over the rechartering of the Second Bank of the United States the lines were drawn between two masters that any capitalist banking and financial system needs to serve: one requires an assurance that the financing needed for the capital development of the economy will be forthcoming and the second an assurance that the result will provide a safe and secure payments mechanism. In this conflict the Second Bank forces around Biddle represented the creditor and monied interests, who emphasized the need for a safe and secure payments mechanism, and the forces around Jackson represented the entrepreneurs of the west, who were conscious of the need for financing to develop the continent.

It was understood then and needs to be understood now that development financing involves taking risks that projects would not perform up to the expectations of their promoters and financiers and opens the way for fraud and unsafe banking procedures. The need is for a regulatory and supervising authority for the financial system that accepts that financing development opens the system to losses that have the potential for adversely affecting the safety and security of the economy's payment facilities and allows for this possibility by attempting to insulate the payments sytem from the consequences odf such losses. The problem therefore is to provide for protecting the payments system from the consequences of the losses which may ensue from development financing. After the experience of the long decade 1980-9192 it is clear that the problem of creating a financial system that simultaneously finances development and protects the payments system against risks associated with non-performing assets is still with us.

The existing regulatory and supervisory structure for financial institutions provides the initial conditions for any reform of the regulatory and supervisory structure. The players in the current game of developing a supervisory and regulatory system for the financial structure and payments mechanism include

1. The Comptroller of the Currency
2. The Federal Reserve System
3. The Deposit Insurance Facility
4. The Securities and Exchange Commission
5. The Treasury Department
6. The Congress.

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2. The Comptroller of the Currency

The Comptroller of the Currency originated in the National Banking Act of 1863. The National Banking Act was put in place as a reaction to the crisis of 1857 and because of the needs of war financing. Before the National Banking Act there was no unified currency for the United States. As far as banking was concerned each state was sovereign. Except for coinage, the provision in the Constitution that the Congress provide for a money supply whose value it would regulate was ignored.

The National Bank Act provided for a set of banks - the national banks - that were to be chartered by the Federal Government. These banks were to have a monopoly of note (currency) issue: the bank notes of the State chartered banks were to be taxed out of existence.

At the time of the passage of the National Banking act it was believed by many that the taxing of bank notes issued by State chartered banks would drive these banks out of business. However as the National banks were not granted trust powers, state banks survived as trust companies and as providers of checkable deposits and non checkable savings banks. The dual banking system is a product of the survival of state chartered banks. As the capital requirements for national banks were greater than those that many states required for state chartered institutions, the state banks played a major role in smaller towns as well as in the neighborhoods of our cities. State banks were of special significance in the emerging ethnic communities, both urban and rural, of the period between the Civil War and the Second World War.

National bank notes were secured by United States Government Bonds: these bonds were the only assets that could serve as an offset to bank notes on bank balance sheets. The Comptroller of the Currency was the chartering agency for National Banks and was to assure that these banks were safe and sound and that the law with respect to the issuance of currency was honored.[2] As the economy grew after the civil war the national debt that could be used as the asset offsetting bank notes did not grow: the currency supply became inelastic and could not respond to the needs of trade. The inelasticity of the supply of financing from banks together with the inelasticity of the money supply led to chronic deflation and to constraints on the expansion of the economy. William Jennings Bryon's "Cross of Gold" speech, and the politics that went with it was a response to this state of events.

The National Banking act also defined a hierarchy of bank locations and bank functions. Locations were classified as sites for central reserve city banks, reserve city banks and country banks. The capital and reserves of banks in this hierarchy varied: furthermore reserve deposits of country banks could be held in city and reserve city banks and reserve deposits of city banks could be held in reserve city banks. (New York, Chicago and St. Louis were reserve cities) This hierarchy of banks meant that a drain of

2. In a little noted provision the Federal Government guaranteed that the bank notes would always be at par: the provision for the guarantee of bank notes can be viewed as a forerunner of deposit insurance.

currency into circulation in the countryside, as well as an increase in the volume of deposits in the country side led to an drain of reserves from banks in the reserve cities, New York, Chicago and St. Louis.[3]

A network of correspondent banks developed around the main reserve city banks in New York, Chicago and St. Louis. Country and city banks used the facilities of their reserve city correspondent banks for the processing of checks, as sources of financing for credits that were too large for the country banks and as sources of assets in the form of participations in loans that the center banks originated. When the National Banking System was folded into the Federal Reserve System the hierarchy of bank locations was preserved and the correspondent relations continued.

The national banking system did not have par clearing of checks. From 1863 until the Federal Reserve System instituted par clearance, the check payment system involved either checks being deposited or encashed at a discount or the payment of fees to banks for checks drawn on a bank in a Central Reserve City (New York, Chicago or St Louis): par clearance was practiced among Central Reserve Cities. As a result of this fee for service arrangement, the check cashing and payments mechanism was a profit center for many smaller and rural banks.

3. The Federal Reserve System

Just as the National Banking System was a response to the crisis of 1857, the Federal Reserve System was a response to the crisis of 1907. After that crisis a consensus developed that one flaw of the national banking system centered around the inflexibility of the currency: the government debt was not large enough around to serve as the basis for the currency supply. The supply of currency could not expand when the seasonal flow of

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3. One aspect of this flaw in the banking structure was that each autumn, as the movemwnt of crops led to an increase in currency and deposits the interior, a financial stringency developed in New York. This stringency led to threats of financial disarray almost every autumn. The Federal Reserve Act was designed to overcome this flaw.

commerce drew funds from the eastern banks to banks in the agricultural west. The Federal Reserve Act was to provide a currency and an ability to finance that was responsive to the needs of trade.

In contrast to the national banking act the initial Federal Reserve Act forbad the use of government debt to offset currency. The offset to currency, on the books of the regional Federal Reserve Banks that were to supply currency, was to be either gold (minimum of 40%) or rediscounted commercial paper.[4]

The commercial paper so used was called real bills. These real bills were documented debts that reflected goods in the process of trade that had been discounted at a bank by a business customer. As the hildoing bank's need for reserves increased, the bill could be rediscounted at the Federal Reserve Bank of its district.

The Federal Reserve Act in its very conception was based upon a doctrine, called the real bills doctrine, which held that <u>if</u> the flexibility in the money supply was the result of the discounting by banks and the rediscounting by the central bank of bills which represented goods in the channels of commerce or trade <u>then</u> the economy would have the correct amount of money. This "correct amount of money" was not only secure in its value but also provided for the financing of the inventory part of investment. This amount of money was correct in the additional sense that it was temporary, for the money would be extinguished when the bill came due and the requisite sums were paid to the bank. A real bill was a self liquidating instrument.

This doctrine was flawed for a money value of the real bills were discounted and any rise (fall) in prices would lead to a rise (fall) in the value of bills that were eligible for

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4. Federal REserve Notes are even now the liability of the regional Federal Reserve banks. The signature of the Secretary of the Treasury and of the Treasurer of the United States on the face of the bill are really "financial" anachronisms: they are statements that this bill conforms to the rules by which these reserve banks are authorized to issue such bills.

discounting: both inflation and deflation could feed upon such a rise or fall in the value of bills eligible for discounting.

The initial Federal Reserve act provided for a two part balance sheet. Ignoring both the role of the Federal Reserve Banks as the government's deposit bank and the equity of the Federal Reserve Banks, the Federal Reserve Banks had two liabilities: reserve deposits of member banks and Federal Reserve notes (currency). The Federal Reserve Bank's balance sheet was split between these liabilities. To offset Federal Reserve Notes the banks needed a minimum of 40% gold and a maximum of 60% eligible paper, i.e.assets which the federal reserve acquired by rediscounting real bills of member banks.[5] To offset deposits of member banks the Federal Reserve Banks needed 25% gold and 75% of any other asset. Government debt could serve as an asset offsetting member bank deposits but were not eligible for bank notes.[6]

This system lasted until the great depression. Under the rules of the pre great depression Federal Reserve an internal currency drain, due let us say to a heightened skepticism about the viability of banks, led to an increase in the gold needed to offset Federal Reserve Note and Deposit liabilities. Furthermore a decline in the money value of

5. In the 1913 bill, banker's acceptances, which reflected goods in the process of production, were also eligible as "backing" for currency. During the 1920's the Federal Reserve System tried to establish a market for banker's acceptances and failed. The Federal Reserve was trying to set up markets which would enable it to deal with markets rather than individual banks. It was trying to have a structure of finance in the United States which emulated Britains.

6. During the great collapse of the American banking system and economy between 1929 and 1933 there was an increase in currency outstanding, even as there was a decline in the value of bills that were discounted. As the Federal Reserve supplied currency the ratio of gold required not only shifted from 25% to 40% but, because of the shortage of eligible paper, on the margin Federal Reserve Notes were absorbing 100% gold. Even as there was a large flow of safe haven funds and of gold to the United States fears were voiced that the United States was in danger of running out of gold. The flaw in the 1913 arrangements was at least in part responsible for the failure of the Federal Reserve to play a positive role as the United States' banking and financial system degenerated into chaos in the winter of 1932-33.

the eligible paper meant that on the margin Federal Reserve Notes could require 100% gold as the offsetting asset.

The original Federal Reserve System assumed that banks would regularly be financing part of their position by discounting paper at their regional Federal Reserve Bank. Member banks which regularly submitted paper for rediscounting were in a customer relation with their regional Federal Reserve Bank. As a regular borrower it was "normal banking usage" for member banks to demonstrate their credit worthiness to their lending Federal Reserve Bank. Federal Reserve Bank regulation, supervision and examination of memeber banks was a legitimate activity as long as memeber banks were regularily discounting paper at the Fed.

It is worth noting that there was an element of micro-management of bank lending in the doctrine of "eligibility" which underlay the rediscounting function of the Federal Reserve System. Loans based upon a borrowers general balance sheet and cash flow strength were not "eligible" for rediscounting, whereas loans with proper documentation that represented goods taken into manufacturing or trading inventories or in transit were eligible.

In the vision of the role of banks in the economy that underlay the Federal Reserve act banks were not to finance the putting in place of durable capital assets. The common role of banks as the providers of construction finance even as Savings nad Loan Associations and Insurance companies provided take out financing was foreign to the structure of teh Federal Reserve act. The vision of the act restricted the role of banks to the financing of the movement of agricultural products from farm to city and abroad and of imports and manufacturing from source to market. The image of what went on in the economy that underlay the 1913 act was obsolete even as the act was being enacted.

In the discounting and rediscounting banking system Federal Reserve Bank inquiries as to the soundness of member banks business practices had a legitimacy that was derived from the customer relation of the member banks. This customer relation lent legitimacy to Federal Reserves examination and oversight relation. This legitimacy vanished when open market operations replaced discounting as the main instrument of Federal Reserve operations which affected the reserve base of the commercial banks.

There are many differences between a central bank that feeds reserves to member banks by way of the discount window and a central bank that feeds reserves to banks by way of the market for government debt. In a discount window - eligible paper system the Federal reserve sets the discount rate and then stands ready to supply all funds required at this rate: presumably the discount rate is somewhat higher than the rate at which banks would finance their position from their normal customers: the discount rate was a penal rate. The control over the quantity was through the rate, but the focus was on financing terms for banks which quite naturally moved to the financing terms for bank customers.

In an open market approach to reserve banking the emphasis is upon the quantity of reserves supplied, especially as the interest rate on the securities purchased and sold by the Federal Reserve may be quite different than the interest rate at which loans were being made.

It is also worth noting that there is a legitimate function for regional Federal Reserve banks in a rediscounting system especially in a world where communication and transportation are time consuming. It is hard to find a serious reason for the regional Federal Reserve Banks in a central banking system that relies upon open market operations and with our late 20th century capacity to communicate and keep and retrieve records. Knowledge about the credit worthiness of banks and bank customers by the central bank may have been important in determining whether a particular bank was worthy of access to the discount window 80 years ago, but such knowledge is of little significance in the modern world where individual banks buy their reserves on the Federal Funds market and Federal Reserve Operations are almost exclusively open market operations which aim to get the correct amount of a global aggregate of bank reserves.

A Federal Reserve System, whose sole concern is the provision of the right amount of reserves to the deposit banks and where the present anomalous archaic institutions, the 12 Federal Reserve Banks, become regional offices of the Board of Governors with a manager rather than a President, makes a great deal of sense. The regional banks serve no useful function that could not be as well or better served by regional offices of the Federal Reserve system.

It is difficult to believe that any provision for the regional Federal Reserve Banks would be made if the Federal Reserve System were being set up today. The First and Second Banks of the United States were wisely set up with a date certain at which the charter would terminate. The Congress in 1837 was faced with the need to recharter or eliminate the second Bank of the United States. If the Federal Reserve had a charter which ended in 1994, I feel certain that the twelve Federal Reserve districts with Federal Reserve Banks would not be enacted. It is difficult to find a serious purpose that these banks serve: they are expensive boondoggles.

There may well be a need for the Federal Reserve System to have branch banks in the main money markets to carry out operations. In particular some of the Federal Reserve's operations that affect the reserve base are executed by teh Federal Reserve Bank of New York. In a reorganized Federal Reserve System with a somewhat enlarged Federal Reserve Board of Governors one member could be designated by the Board as the operating head of the Federal Reserve Branch in New York.

3. The Deposit Insurance Facility

Since the 1930's the FDIC, which insured deposits at Commercial and Mutual Savings Banks, and the FSLIC, which insured deposits at Savings and Loan Associations have been the main Federal Government Agency with which banks had ongoing financial relations. As these organizations were holders of a contingent liability on the deposits of banks and S&L"s they had an underwriter's right and duty to be knowledgeable about the business operations of those they insured. These agencies were responsible for the integrity of the insurance funds. As the lending (underwriting) standards of those they insured could place the funds at hazard they needed regular oversight to determine whether the insurance should be kept in force for any particular bank.

The systematic deterioration of underwriting standards at Savings and Loan Associations occurred when S&L"s were permitted to finance and even to acquire land for development and later when they were allowed to acquire portfolios of non-investment grade bonds. Any agency which had as an objective the preservation of the integrity of deposit insurance would have forbidden the use of insured funds for such placements. It was a gross neglect by the responsible officials not to withdraw insurance from such organizations or alternatively to raise the rates for the insurance to such levels that the stretching of the risk parameters by particular banks would have been unprofitable.

The root of the S&L debacle of the late 1980's early 1990's lay in the interest rate inversion that was part of the Federal Reserves anti-Inflation monetarist posture of the late 1970's and 1980's. Any bank regulatory and supervisory agency worthy of its keep would have had to go public in opposition to the Federal Reserve's unwarranted excursion into practical monetarism in the Volcker years because of what the Volcker policy was doing to the net worth of the savings institutions. The destruction of the savings banks and the thrifts, which, shades of Jimmy Stewart served our country so well, and the enormous increment to the federal debt that this led to was a consequence of ill conceived if not irresponsible Federal Reserve policies. If deposit insurance, bank supervision and bank examination, and a successful home financing set up centering around thrift deposits and insurance reserves, are to be part of the United States' economic structure in the third millennium of the common era then the cotton picking hands of the Federal Reserve System should be kept out of the bank and financial system's supervision, regulatory and examination process.

The Securities and Exchange Commission

Perhaps the most significant New Deal reform was the establishment of a rule of law in both the governance of corporations and the operations of the markets for corporated debtsd and equities. The essential character of the reforms was the recognition that the the economy was a corporate capitalism and that this implied that information about the operations of corporations was to be broadly disseminated, available to all who might possibly have an interest in taking a position in an equity or a debt liability of the company. Furthermore as the taking of such positions was acomplished through marketsd the markets must be open and transaction information must be both honest and broadly available. Governence, information about the earnings and balance sheets of corporations, the operations of financial markets and the operations of financial firms were to be transparent.

Note that the United States' requirements in re transparency are stricter than those of most (almost all?) other capitalist countries. There is always pressure for a relaxation of the standards of transparency. The image in the United States' transparency requiirements for financial markets is that of the individual position taker, an individual whose position is modest.

The growth of large position takers in the form of Mutual and Pension Funds has compromised the transparency of financial markets as changes in positions by such entities often takes the form of sales to position taking traders who then sell out their position over time.

One element that the Congress needs to address is the relation between the Unified Banking and Finance Supervisory Commission and the Securities and Exchanfge Commission: this has already surfaced in the question of whether particular Bank Liabilities are securities in the sense of the Securities Commission and therefor require the public supporting information required of a securities issue.

It is worth noting that transparency implies that there exists a set of businesses that analyse and evaluate the information about individual issues. The security analyst is a necessary adjunct to the operations aof a corporate economy where transparency is the protecion of the individual investor.

The Office of the Secretary of the Treasury

As the ultimate responsibility for deposit insurance rests with the Treasury and as the fiscal position of the government is a main determinate of flow of aggregate profits the Secretary of the Treasury needs to be "represented" in the deliberations of the various banking and financing agencies: The Federal Reserve System, The Bank Regulatory agency and the securities and Exchange Commission.

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#. FINANCIAL SYSTEM EXAMINATION AND SUPERVISORY AGENCY.

There is a need for a unified financial system supervisory agency. Ever since the financial system has evolved away from the dominance by banks there is a need for an agency that can look at the financial system in a unified and coherent way. Over the years The Federal Reserve has demonstrated an inability to deal with financial crises. In fact its misguided and seriously wrong headed operations in the late 1970's early 1980's are undoubtedly responsible for the malaise that has struck the American Economy.

The home financing set up that the United States has had ever since the great depression rests upon a long term fixed interest rate mortgage. The weakness in our system is that we melded this mortgage with a set of savings banks which had to meet the short term market for its funding. This set up was viable as long as the Federal Reserve operated to keep interest rates within the boundries that would keep the long lenders solvent. The Federal Reserve ignored the effect that its operations had upon the solvency of the thrifts and conservative insurance companies when it acted to create and sustain interest rates that were incompatable with the long term assets in the portfolios of these institutions. The experience of the past decae and the prospects for the further development of financial instiutions in the next decades indicates that the supervisory, regulatory and examining functions be carried out by an organization responsible to the Congress that is independent of the Federal Reserve Board of Governners but not of the Treasury.

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