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## A STATE'S RESPONSE TO THE UNITED STATES TREASURY DEPARTMENT PROPOSALS TO MODERNIZE THE NATION'S BANKING SYSTEM

*JILL M. CONSIDINE\**

### INTRODUCTION

**T**HE theme of your Colloquium is "The S&L Crisis: Death and Transfiguration." That transformation surely encompasses a broader spectrum of financial institutions than S&Ls, and it could precipitate a crisis for the dual banking system, that unique blend of state and federal institutions. Any restructuring of the entire financial services industry will have a profound impact on the nation's regulatory structure. The primary casualty of the S&L crisis was not insolvent thrifts, or shareholders left holding worthless paper, or even the taxpayers. The primary casualty was public confidence in our banking system. And genuine transfiguration can only be achieved by renewal of public confidence.

My comments today<sup>1</sup> about the S&L crisis come from a state regulator's perspective, and I will focus my discussion on its potential to harm the dual banking system. But it should be understood that the S&L crisis is merely part of a continuum of change, changes reflected in the statutory and regulatory proposals now being advanced—changes that may ultimately include the blending of banking and commerce.

There are few who disagree that banking reform is essential if the United States is to maintain a safe and competitive banking system. Reform requires expanding bank powers, consolidating banks and eliminat-

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This speech was given by Superintendent Considine as part of the annual Financial Institutions and Regulation Symposium at the Fordham University School of Law.

1. Superintendent Considine's February 17, 1991 address preceded the formal introduction of the Treasury Department's bank reform legislation by several weeks, and thus does not reflect changes made in the Department's original proposals, which were publicly unveiled on February 5, 1991.

ing geographic constraints. What it does *not* require, however, is blanket homogenization or nationalization of the banking system without any recognition of the variety of financial institutions and the markets they serve. The dual banking system recognizes this geographic diversity and has been a lasting strength of the American banking system for more than 125 years.

## I. THE DUAL BANKING SYSTEM

The starting point for any understanding of the dual banking system is the fact that the United States Constitution gives no power to Congress to establish banks. For the first seventy-five years of our history, there was only state banking, except for brief periods when the First<sup>2</sup> and Second<sup>3</sup> Banks of the United States were in existence. Only when the State of Maryland sought to tax the First Bank of the United States and the matter was taken to the Supreme Court did the great Federalist Chief Justice John Marshall establish the right of the federal government to create and operate a system of national banks based on a concept of powers implied by other enumerated powers that the Constitution gave Congress.<sup>4</sup>

When the National Bank Act of 1864<sup>5</sup> was passed to finance the Civil War, it provided for a co-equal system of national banks, regulated and supervised by the Office of the Comptroller of the Currency (the "OCC"), and state banks, regulated and supervised by state banking departments.

The dual banking system as we know it can be dated to the Federal Reserve Act of 1913<sup>6</sup> and the Banking Act of 1933,<sup>7</sup> with the entry of the federal government into the regulation of state member banks through the Federal Reserve Board and the Federal Deposit Insurance Corporation (the "FDIC"). This extraordinary duality in banking reflected resistance to the establishment of concentrated financial power.

Although this divided system arose from a historic fear of national power, state-chartered banking earned another, more significant role. It is at the state and local level that banking innovations have traditionally been developed. It is here that bankers know the needs of their customers, the strength or weakness of their local economies and the products to offer to attract new business. And it is at the state level that supervisors have first-hand knowledge of and experience with bank managements. Also, state regulators often have significantly broader functional responsibility and experience than their federal counterparts because they must

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2. The First Bank of the United States existed from 1791 to 1811.

3. The Second Bank of the United States existed from 1816 to 1836.

4. See *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 326 (1819).

5. Ch. 106, 13 Stat. 99 (1864).

6. Ch. 6, 38 Stat. 251 (1913).

7. Ch. 89, 48 Stat. 162 (1933).

typically regulate a broad range of financial entities in addition to depository institutions.

For example, here in New York, we have responsibility for regulating state-chartered thrifts, credit unions and banks.<sup>8</sup> At the federal level, each of these types of financial institutions today has a different regulator—the Office of Thrift Supervision (the “OTS”) for national savings banks and S&Ls, the National Credit Union Administration (the “NCUA”) for federal credit unions, and the OCC for national banks. There are differences among the states as well. In California and Texas, for example, there is one regulator for the S&Ls and another for commercial banks.

Overlying this banking regulatory structure, which exists at the federal and state level, is deposit insurance. For thrifts there is the Savings Association Insurance Fund (the “SAIF”), the successor to the Federal Savings & Loan Insurance Corporation (the “FSLIC”), and for commercial banks there is the Bank Insurance Fund (the “BIF”). Both of these are administered by the FDIC. When a bank, either state or federally chartered, establishes a holding company, the Federal Reserve acquires jurisdiction over that entity.

Proposals have recently been made that may significantly change this layered system of regulation. They are part of the Treasury Department's recommendations for “Modernizing the Financial System,” which were part of a report published in February 1991.<sup>9</sup> What will eventually be enacted by Congress is anyone's guess, however, and I can only offer my assessment of these various proposals and make my own suggestions.

As New York's Superintendent of Banks for almost six years as well as a past chair of the Conference of State Bank Supervisors (the “CSBS”)—an organization representing fifty-four regulatory agencies supervising 9,000 state-chartered banks in fifty states, three territories and the District of Columbia—I know the scope of state supervisory responsibility in general and view it with a renewed sense of respect.

In addition to commercial banks and savings banks, my state colleagues and I supervise a vast number and variety of financial institutions. In New York, for example, the Banking Department regulates almost 4,000 financial institutions with \$1 trillion in assets. Overall, thirty-six state banking departments supervise savings and loans and credit unions; twenty-eight supervise bank holding companies; seventeen supervise first and second mortgage companies; forty supervise trust companies; and twenty-eight regulate money order companies. This is

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8. See N.Y. Banking Law, Articles III (Banks and Trust Companies); VI (Savings Banks); X (Savings and Loan Associations); and XI (Credit Unions)(McKinney 1990 & Supp. 1991).

9. Treasury Dep't, *Modernizing the Financial System* (1991) [hereinafter *Treasury Reform Proposal*].

certainly a far broader spectrum of financial regulation than exists at any federal agency.

State-chartered banks range in size from a \$3 million bank in Georgia to multi-billion dollar money-center banks in New York. They represent two-thirds of all commercial and savings banks in the nation with \$1.2 trillion in deposits and \$1.6 trillion in assets, roughly forty-five percent of all the assets and deposits in the nation's banks. In addition, state-chartered foreign agencies and branches hold \$550 billion in United States-based assets, ninety-four percent of all such assets held in this country.

It is at the state level, too, that innovation begins, with market-driven products and services that are often models for Congressional legislation. Although Congress has not acted, sixteen states already authorize insurance powers for their banks, twenty-seven permit securities activities, and twenty-seven allow some sort of real estate equity investment or development. It is the states that first allowed banks to establish branches on a state-wide basis,<sup>10</sup> to develop interest-bearing checking accounts,<sup>11</sup> and to permit electronic funds transfer,<sup>12</sup> automated teller machines<sup>13</sup> and Community Reinvestment Act (the "CRA") disclosure,<sup>14</sup> just to name a few state innovations that are now common throughout the banking system. And it was New York State that pioneered deposit insurance back in 1829—more than 100 years before the FDIC was created.

New York State also established the expedited-funds-availability requirements for banks,<sup>15</sup> rules establishing time periods for withdrawal of funds after a deposit, which eventually became a model for Congressional action.<sup>16</sup> Similarly, we took the lead in licensing foreign bank branches and agencies<sup>17</sup> and in establishing credit card disclosure rather than upper-limit caps on interest rates.<sup>18</sup> Even in the area of interstate

10. See The Conference of State Bank Supervisors, *State of the State Banking System* 8 (1989) [hereinafter *State Banking System*]; see generally, The Conference of State Bank Supervisors, *Profile of State-Chartered Banking* 111-19 (13th ed. 1990)(listing banks permitting branches on state-wide basis) [hereinafter *State-Chartered Banking*].

11. See *State Banking System*, *supra* note 9, at 8.

12. See The American Bankers Ass'n., *State Bank Law Service* 180 (1978)(Massachusetts, Oregon and Washington permitted electronic funds transfer before federal government); *State Banking System*, *supra* note 9, at 8 (1989); see generally *Profile of State-Chartered Banking*, *supra* note 9, at 245-47 (listing states permitting electronic funds transfer).

13. See *State Banking System*, *supra* note 9, at 8; see generally, *Profile of State-Chartered Banking*, *supra* note 9, at 248-50 (listing states permitting automated teller machines).

14. See *State Banking System*, *supra* note 9, at 9.

15. See N.Y. Banking Law § 14-d (McKinney 1990); N.Y. Comp. Codes R. & Regs. tit. 3, §§ 34.1-34.6 (1989).

16. See Competitive Equality Banking Act of 1987, tit. VI, Pub. L. No. 100-86, 101 Stat. 552 (1987); see also 12 C.F.R. §§ 229.1-42 (relating to fund availability, disclosure and collection of checks)(Reg CC)(1990).

17. See N.Y. Banking Law Article V (McKinney 1990 & Supp. 1991).

18. See, e.g., N.Y. Banking Law § 108(5)(b) (McKinney 1990)(disclosure of changes in lending rates); Gen. Bus. Law § 519 (McKinney 1990)(disclosure by commercial estab-

banking, progress was made at the state level and I think the result was far superior to anything Congress could have fashioned from both a political and regulatory perspective. New York acted in 1981 to allow reciprocal interstate banking.<sup>19</sup>

And in 1986, New York, in response to the needs of some of its multinational banks, issued an interpretation of the "engaged principally" language of the Glass-Steagall Act,<sup>20</sup> signalling our determination to loosen strictures against bank participation in securities underwriting. Glass-Steagall,<sup>21</sup> passed by Congress in 1933, was intended to insulate bank depositors from the perceived risks involved when commercial banks dealt in securities, owned brokerage firms or engaged in investment banking activities such as underwriting. In New York State we have our own version, called the "mini" Glass-Steagall Act.<sup>22</sup> Our "engaged principally" interpretation allowed banks to participate in securities underwriting up to twenty-five percent of assets to enable both large money-center banks and smaller banks to participate.<sup>23</sup> Similar flexibility, though only with a significantly lower percentage of assets, and thus practical only for large money-center banks, was subsequently granted under Federal Reserve and OCC interpretations of the federal statute.

Again and again, it is the local financial institutions and state regulators that take the lead in the development and supervision of banking and other financial services. Obviously, the current Treasury reform proposal is trying to create new momentum for reform in this session of Congress, even though many members are still wary of deregulation following the thrift crisis. So it is up to those of us who want reform—and almost all regulators do—to convince those who fear further deregulation that their fears are misplaced. Let me spend some time describing deregulation of the thrift industry, deregulation that was appropriate and necessary but did not go far enough.

## II. THE THRIFT CRISIS

Bankers and bank regulators often look back to the 1950s as the good old days and picture a time when there were simple rules, when bankers exuded confidence and banks epitomized security. We had learned the economic lessons from the 1920s and 1930s, we had grown rich in the years immediately following World War II, and the financial community

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ishments honoring credit cards); Gen. Bus. Law § 520 (McKinney 1990)(disclosure in application forms or solicitation for credit cards).

19. See N.Y. Banking Law § 142-b (McKinney 1990).

20. See Letter from Barbara T. Barrantes, Deputy Superintendent of Banks and Counsel, to Paul L. Lee, Shearman & Sterling (May 4, 1987); Letter from Jill M. Considine, Superintendent of Banks, to Morgan Guaranty Trust Co. and Bankers Trust Co. (Dec. 23, 1986).

21. 12 U.S.C. § 24 (1988).

22. See N.Y. Banking Law § 103(9) (McKinney 1990).

23. See *supra* note 19.

was doggedly pursuing its mission of financing America's unprecedented growth.

The rules were rigid and flexibility was nil. It was banking by the numbers: numbers three, six, three. You borrowed at three percent, loaned it out at six, and hit the golf course by three! And that was all there was to it. As simplistic as it sounds, it does characterize the banking environment before deregulation, just as it helps us to understand the origins of the thrift crisis and the remedies that were introduced to reform the system.

It is fair to say that the thrift crisis is the most serious banking failure since the Great Depression: certainly it is in terms of dollars lost and the obligations it imposes on us as taxpayers; certainly it is in its enormous ancillary impact on all other financial institutions, including a pervasive loss of public confidence in the entire banking system.

Years ago, when Congress first determined that there was a need for a separate set of financial institutions devoted to home financing, it created a separate federal regulatory, deposit insurance and liquidity system for the thrift industry.<sup>24</sup> Today, critics contend that the thrift industry was founded on an inherently flawed premise—long-term mortgages financed by short-term deposits—but no one disputes that the system served housing finance well for at least thirty years after its creation.

So, what went wrong? The causes of our current problems are far more complex than those looking for a simple villain in deregulation would admit. Basically, the market changed and the system did not respond, a scenario that must be avoided in any future bank deregulation.

In the 1960s, deposit interest rate control was extended to the thrift business as a way to keep mortgage rates low by putting a lid on what thrifts could pay depositors. This was an early warning of the serious structural problems that were developing. Soon thereafter, various blue-ribbon commissions and specialists began to study the industry.

In the early 1970s, the consensus view identified two emerging problems: (i) the danger of disintermediation—the movement of funds from low-yielding accounts at traditional banking institutions to higher yielding investments in the general market—which stemmed from a highly regulated depository institutions system; and (ii) the inability of the U.S. financial system to keep pace with growing domestic and international competition.<sup>25</sup> As a result of the findings, the call for deregulation was sounded.

At first, policy makers were not listening. But in the mid-1970s, as

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24. See Federal Home Loan Bank Act, ch. 522, 47 Stat. 725 (1932)(establishing Federal Home Loan Bank Board); National Housing Act, ch. 847, 48 Stat. 1246 (1934)(establishing FSLIC).

25. See generally Wilmarth, *The Expansion of State Bank Powers, the Federal Response, and the Case for Preserving the Dual Banking System*, 58 Fordham L. Rev. 1133, 1144-47 (1990)(discussing increased competition to banks, declining bank profitability and increased bank failures).

money market mutual funds appeared, the specter of disintermediation loomed large and thrifts began to lose deposits at an alarming rate. In 1977, money market funds totaled \$3 billion; by 1982, the amount had jumped to \$233 billion.

Because of the importance of fixed-rate mortgages in their asset portfolios, thrifts had always been vulnerable to rising interest rates. Their reliance on fixed-rate mortgages—all but mandated by state usury-law ceilings—locked them into low rates of return. As long as interest rate fluctuations were moderate, fluctuations in thrift earnings were also moderate.

That changed dramatically in the late 1970s when inflationary pressure boosted interest rates substantially and drove up the cost of funds. Depository institutions experienced substantial deposit outflows, interest ceilings at banks and thrifts were raised, new deposit instruments were developed and eventually deposit rate ceilings were eliminated altogether. In New York, for example, our thrifts had to pay ten percent or more to attract deposits, yet were still prevented by usury laws from charging more than 8.5% for mortgages.

Regulator reaction was slow. At first thrifts were allowed to issue longer-term certificates at somewhat higher rates. Later, in 1978, short-term, competitively priced six-month certificates were approved. It soon became apparent that regulators had no choice but to relax rigid deposit rate constraints if the housing industry was to be assured a continuing flow of mortgage credit. As the cost of funds increased at thrifts, however, interest margins declined sharply, turning negative in 1980 and remaining negative through 1982. As a result, thrifts experienced substantial operating losses. Between 1980 and 1983, about 470 FSLIC-insured institutions were closed or merged to avoid failure. In New York State alone, sixty-nine thrifts, both savings banks and S&Ls, were merged into healthy state and federal institutions.

The Depository Institutions Deregulation and Monetary Control Act of 1980<sup>26</sup> was the result of a national effort to deregulate deposits. That Act initiated the phased, six-year deregulation of bank and thrift deposit rates. But it was only the liability side of the ledger that was deregulated. You could pay market rates for funds but were still limited as to where they could be placed.

While the Act accomplished its aim of deregulating the deposit side, where the disintermediation problems were readily apparent, it neglected to deal with the asset side. This was recognized later and hurried attempts were made over the next two years to grant new asset powers in three major ways: (i) by federal legislation; (ii) by action of certain state legislatures; and (iii) by the Garn-St Germain Depository Institutions Act of 1982.<sup>27</sup> No one could have envisioned how imprudently these

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26. Pub. L. No. 96-221, 94 Stat. 132 (1980).

27. Pub. L. No. 97-320, 96 Stat. 1469 (1982).



powers would in some cases be used.

To add to all the other problems, thrifts in particular regions were buffeted by deteriorating economic conditions as key sectors of local economies took a plunge. At the time, this was clearly an important factor in the southwestern United States, just as it is today in New England and the Mid-Atlantic states.

To prevent the industry from being further overwhelmed, efforts were made to bolster industry earnings and net worth in a variety of ways. These included government-issued, capital equivalent, net worth certificates; deferred losses on asset sales; and favorable accounting treatment in other areas, including the acquisitions of failing institutions. These devices did not contribute to "real" earnings or net worth. But they delayed technical insolvencies and bought time, allowing institutions to stay alive while they tried to grow their way out of their problems. In some instances the time was used well; too often, however, it was not.

For thrifts that sought to grow out of their problems, higher yielding assets appeared to offer the best opportunity to counteract previous losses. Some savings institutions did turn to high-risk activities in the hopes of making quick profits. Instead, many generated further losses. A number of these institutions simply did not have the expertise to make such loans prudently; some were victimized by dishonest operators inside and outside their institutions; and real estate markets subsequently deteriorated, most in precisely those areas where loans could most readily be booked. Then, just as interest rate problems abated nationally, massive asset quality problems cropped up among many institutions.

This institutional bind should not have been hard to anticipate. An institution without capital has substantial incentive to gamble its way to solvency. The dramatic doubling of the size of the thrift industry between 1979 and 1985 reflects at least in part the efforts of many thrifts to grow their way out of their problems. In other sectors of the economy, creditors would have prevented such expansion. But creditors have little reason to exercise discipline when funding comes from government-insured deposits.

There has been substantial debate over whether expanded powers were good or bad for S&Ls and whether they contributed to current problems.<sup>28</sup> In some sense, they did contribute. However, it is important to have some perspective on this issue and to recognize that only certain poorly managed institutions took inappropriate risks utilizing the new powers, while better run institutions pursued such opportunities wisely.

Congress, some state legislatures and state regulators, and the Federal Home Loan Bank Board all played a role in mismanaging the situation. Capital requirements that were insufficient to cushion traditional thrift

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28. See, e.g., N. Strunk & F. Case, *Where Deregulation Went Wrong: A Look at the Causes Behind S&L Failures in the 1980s* 54-88 (1988)(discussing role of expanded bank powers and relaxed regulations in S&L crisis).

risks were certainly not sufficient to cushion riskier ones. And examination and supervisory policies were not prepared to deal with riskier asset portfolios.

Certainly, a breakdown in supervision was a major contributor to the problem. As many of you know, New York and many other state banking departments spend months evaluating each new charter request, thoroughly investigating the quality and experience of proposed directors and senior managers, assessing the competitive impact of the institution and critically reviewing its business plan and profit projections. One state apparently did little if any of this analysis as it chartered 200 thrifts in 400 days. And, lest we blame only the state, remember that the then federal insurer—the FSLIC—approved deposit insurance coverage for these institutions.

On the whole, regulators struggled mightily to keep the system alive in the hopes of better days ahead—but they were understaffed, underpaid, undertrained and, frankly, overwhelmed. In part there was a failure to recognize the dangers inherent in deregulation that was not properly supervised.

The situation called for strong and prompt action. In New York we were faced with rapidly eroding net worth in institutions that for too long were earning far less on regulated assets than they were paying on deregulated deposits. We vigorously opposed the efforts of some of our institutions to defer loan losses or inflate their assets to prevailing market value, actions that resulted in these sixty-nine state-chartered thrifts being merged into or acquired by stronger institutions.

At the same time, a more paternalistic Federal Home Loan Bank Board allowed insolvent federally chartered institutions to continue to operate in New York and elsewhere, supported mainly by accounting gimmicks. In fairness to the Board, however, few in Congress pressed to solve the problem. What might have been a manageable problem then moved inexorably forward to the crisis we have today.

In fact, if there is a lesson to be learned from the decade of the 1980s, it is this: market dynamics may drive the pendulum of change, but it is the appropriateness of the political response that ensures the viability of the financial system. And it is the adequacy of this political response that will be sorely tested in the weeks and months ahead as Congress debates the bank reform proposals put forward by Treasury.

Perhaps the clearest lesson to emerge from the thrift crisis is that deregulation should not mean decreased supervision. On the contrary, greater flexibility requires greater supervision by both managements and regulators to ensure safety and soundness.

### III. BANK REFORM PROPOSALS

We have already seen how deregulation of the financial institutions industry began in the early 1980s. While the Garn-St Germain Act

sought to halt the thrift crisis, it also increased lending limits for national banks and expanded the lending and investment powers of federal thrifts. As a result, various states acted quickly to grant their state-chartered banks and thrifts these and other new powers—some allowing direct investments in real estate, others granting banks the right to sell insurance and still others permitting some involvement in the securities market.

Throughout the decade it was market forces that shaped the deregulation of our financial institutions, but only incrementally, never in a comprehensive manner. Thus, the current drive towards more comprehensive deregulation must be pushed vigorously forward if our financial services industry is to meet today's challenges, let alone tomorrow's. Although not an instant success and subject to criticism on many fronts, Treasury's proposals for bank and regulatory reform will, I hope, become the catalyst for comprehensive reform.

The most welcome of the proposals deals with the expansion of financial services.<sup>29</sup> Under the plan, well-capitalized banks may own and operate financial affiliates that sell or underwrite securities and mutual funds. They would also be permitted to sell insurance if allowed by state law. In addition, financial services holding companies would be permitted to own well-capitalized banks, and non-bank businesses would be allowed to own financial services holding companies. The proposals also mandate a "safety net" and strict regulation to protect the bank, and require separately capitalized financial affiliates, with appropriate firewalls to insulate their insured deposits.

Of course, the proposals raise concerns because they will have a major impact on states' abilities to exercise their regulatory authority over state-chartered institutions. I will concentrate on four of these concerns—the relationship of banking and commerce; repeal of the Douglas amendment<sup>30</sup> and of the McFadden Act;<sup>31</sup> reordering of the federal regulatory structure; and restrictions on the powers of state-chartered institutions.

Despite concerns among state regulators of the marked shift to federal regulation, there is one thing in which we may all take comfort. Most of our commercial banks are well managed, adequately capitalized, sufficiently reserved and, unlike the thrift industry, protected by a multi-tiered regulatory structure that separates the insurer from the primary state or federal regulator. And regardless of what you read or hear, it is decidedly unlikely that a crisis of the magnitude of the S&L debacle could ever happen to the banks.

E. Gerald Corrigan, president of the Federal Reserve Bank of New York, offered his assessment in a recent speech to the New York State Bankers Association:

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29. See *Treasury Reform Proposal*, pt. one, subpt. VII, at 54-61.

30. 12 U.S.C. § 1842(d) (1988).

31. 12 U.S.C. § 36 (1988).

The problems are there and they are quite real; to be equally sure those problems reflect a nasty blend of cyclical and structural forces; and one can be especially sure, these problems will not be cured overnight. But as we agonize about the problems let us not lose sight of the fact that the banking system has shown, and continues to show, great resiliency in the face of all its difficulties.<sup>32</sup>

#### A. *Banking and Commerce*

Resiliency notwithstanding, most of us concede that life is uncertain at best and the need for additional capital remains as vital as ever. The new Treasury proposals regarding ownership or control of financial holding companies by non-financial companies force us to reexamine the traditional separation of banking and commerce.

Historically, combining the users and suppliers of money has generated strong opposition in the United States mainly because of concerns about excessive concentration of economic power and the need to insulate banks and the deposit insurance system from the fluctuating fortunes of particular companies. But we have often seen that rigid, statutory barriers erected for a different banking environment may be counterproductive in today's marketplace. Hopefully, the Glass-Steagall barriers separating banking and securities are coming down, which is essential if our banks are to compete in a global marketplace.

With respect to the separation between banking and the thrift industry, perhaps some of the difficulties of that industry could have been avoided had capital from the banking sector been available to shore up S&Ls in the 1980s. By "capital" I also mean human capital in the form of oversight by those with experience in commercial lending. While this may not have prevented all of the problems, it would certainly have acted as a brake on some of the riskier ventures if only because shareholder capital would have been at risk.

Now that the banking sector is looking for additional sources of capi-

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32. Mr. Corrigan spoke at the midwinter meeting of the New York State Bankers Association on January 31, 1991. He added:

As of year-end 1990, the total capital resources of the 10 largest banking organizations in the U.S. were \$87 billion, more than three times the level of a decade ago. Over the same time frame, all widely used capital ratios have about doubled.

For these same institutions, loan loss reserves alone now aggregate just over \$21 billion. These reserves, which reflect charges against current income or retained earnings, now represent about two-thirds of non-performing assets. Put differently, these reserves alone now represent a sizeable cushion against future charge-offs, quite apart from the \$66 billion of equity and other capital resources currently available to these institutions.

Having said that, let me quickly add that in the current circumstances I very much believe still further enhancements in capital are needed. That is one reason why I applaud the recent steps taken by a number of institutions in further boosting loan loss reserves and in some cases cutting their dividends—painful as that may have been. . . .

tal, a consensus seems to be forming to break down the barrier between banking and commerce. Countries like Germany and Japan that permit this have not experienced problems. Even in the United States where we have had limited experience with so-called nonbank banks, the elimination of the barrier has not raised significant supervisory concerns. In a number of European countries and in Japan, interlocks between banks, insurance companies, securities firms and business corporations have existed for many years without undue risk. In addition, by owning the stock of a borrowing company, a bank would be able to participate in that company's management decisions, possibly acting as a restraining influence on any risky ventures contemplated by the company.

Certainly, as part of the process of bank reform, we must decide whether the notion that banking is unique should be preserved or whether there are offsetting advantages to the financial system by integrating banking and commerce. It appears that Treasury is siding with those who view the coalescing of banking and commerce as a welcome development. I, for one, believe it is long overdue!

#### B. *The McFadden Act and Douglas Amendment*

Another key element of the Treasury plan<sup>33</sup> is the repeal of the McFadden Act,<sup>34</sup> which gives states control over bank branching within their own borders, and repeal of the Douglas Amendment<sup>35</sup> to the Bank Holding Company Act, which reserves state authority over entry into the state by out-of-state banks. The Treasury proposal would authorize full nationwide banking for holding companies in three years. National bank interstate branching would be permitted immediately wherever interstate banking is permitted, but there would be no preemption of intrastate branching restrictions. Interstate branching by state banks would be authorized only if authorized by the chartering state.

A similar repeal proposal that was introduced in Congress this year would allow a state a certain time period in which to enact a law prohibiting interstate branching, or significantly qualifying the entry of an out-of-state branch.<sup>36</sup> Be assured, I support efforts to permit branching across state lines. But I believe that each state should decide whether it wishes to retain control and supervision over banking activities within its borders.

While it appears that state-law limitations on branching within a state and authorized state bank activities will not be disturbed, the proposal appears to recommend preemption of laws permitting states to determine the terms of entry of other banks and branches into their states. If state laws are preempted, state bank charters will lose their value in relation to

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33. See *Treasury Reform Proposal*, pt. one, subpt. VI, at 49-53.

34. 12 U.S.C. § 36 (1988).

35. 12 U.S.C. § 1842(d) (1988).

36. See H.R. 624, 102d Cong., 1st Sess. (1991); S. 300, 102d Cong., 1st Sess. (1991).

national bank charters, resulting in rapid concentration of banking resources to the detriment of local or state control.

The immediate effect of this proposal in New York would be that national banks could at once come in and begin branching without Banking Department approval. It is ironic that the state banking system, which developed interstate banking and brought it to the level that exists today, would now be so seriously disadvantaged by the proposed changes. New York's Banking Law already exempts national banks from the requirement of out-of-state banks to obtain state authorization to carry on banking functions.<sup>37</sup> We are encouraging interstate branching still further by introducing a bill in the state legislature to permit direct interstate state bank branching on a reciprocal basis. We in New York are no strangers to interstate banking. We have practiced cross-border branching for over a hundred years, albeit with foreign banks, and we were the first state in the United States to permit reciprocal interstate banking.<sup>38</sup>

I submit, however, that a state is responsible for what goes on within its own boundaries and should be permitted to determine entry into state markets as well as branching within the state. Thus, while repeal of both McFadden and Douglas is attractive to some, others fear it will strip states of their historic right to permit out-of-state banks to operate within their borders. Repeal that provides enabling legislation to give states the option of passing their own laws to prohibit or regulate entry and branching within a state's own limits is a far better strategy.

From a national standpoint, however, the consequences of interstate branching need to be thought through. What connection or measure of control will state banking regulators have over branches that operate in their jurisdiction? Will examinations be the responsibility of the chartering regulator, as is the case for the CSBS program for multi-state bank holding company examinations, or for the host regulator, as is the case for foreign bank branches? Will state law, which protects local interests, be applicable to all branches from out-of-state banks, whether state and national, as they are to in-state banks? The proposal recognizes that each state should have appropriate authority to govern the activities of banks and branches operating within its borders. And what authority will a state have to insist that the deposits of its citizens remain in the state branch or branches, or can they simply be repatriated to the headquarters state?

More to the point, what are the tax consequences of repeal for each state? There is no more central issue than taxes, as the revenue base of state after state shrinks. While I am the last one to want interstate branching defeated by the tax issue, it is something that must be looked at carefully by all the states and the federal government. If the economy of any one state is hurt by a decline in tax revenues, it is not going to be a

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37. See N.Y. Banking Law § 200 (McKinney 1990).

38. See S. 3840, 214th Leg. Sess., 1991 (New York).

great place for anyone to continue branching in, or even banking in for that matter.

To show the inequities of this proposal, seven of the ten largest banks are located in New York State. Based on this proposal, two can branch nationwide immediately, while the rest must wait. Is this competitive equality? And what of foreign banks? Twenty-three of the top twenty-five are state regulated and will be prohibited from branching immediately—will this meet the national treatment objective of United States Department of Treasury for the European Common Market for 1992?

And will the proliferation of big bank branches make competition even tougher, forcing all banks to go after the marginal business? Today, there are almost 13,000 banks in the United States and 3,000 savings banks—far too many for all to be profitable. Perhaps we need to think less of expansion and more about consolidation.

In New York, we have repeatedly urged our banks to think about consolidation to strengthen their capital positions and secure greater economies of scale. At the state level we have been flexible in facilitating mergers within markets such as Irving Trust with The Bank of New York, and Fleet/Norstar; between markets such as The Bowery and Home Savings with H.F. Ahmanson in California; and between industries, such as Republic National with the Williamsburgh and Manhattan Savings Banks.

Because there is only a finite amount of credit-worthy lending to go around, competition for a share of the riskier business that is left can only lead to bad loans, reduced profitability and diminished capital. I am convinced that consolidation of banks together with new banking powers is needed if we are to strengthen the nation's banking system.

### C. *New Federal Regulation*

The Treasury plan would establish a single federal regulator for each banking organization.<sup>39</sup> It would combine the OCC and the OTS into a single agency as the primary federal regulator of national banks as well as national and state thrifts. The new agency, called the Federal Banking Agency (the "FBA"), would also supervise the bank holding companies of national banks and national and state thrifts.<sup>40</sup> In cases where bank holding companies have both federal- and state-chartered bank subsidiaries, jurisdiction over the entire organization lies with the charterer of the largest subsidiary bank or thrift. The Federal Reserve would be assigned the function of primary federal regulator of state banks and their holding

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39. See *Treasury Reform Proposal*, pt. two, at 67-69.

40. While the Treasury proposal would place SAIF-insured state and federal savings banks and S&Ls under the jurisdiction of the FBA, there is nothing in the presentation to indicate clearly which federal agency would regulate state-chartered, BIF-insured Savings Banks. There are hundreds of these institutions located in the northeast. The New York State Banking Department supervises 66 such institutions with assets totalling \$83.4 billion.

companies. Finally, the FDIC would be stripped of all supervisory functions except its power to approve deposit insurance requests and liquidation of insolvent institutions.

What struck me most about the administration's proposal was the total absence of input from the states and their banking department representatives. Indeed, one comes away with the distinct impression that every effort is being made to preclude responsible participation of state bank regulators in this debate, even though states regulate two-thirds of all banks in the United States.

From a state perspective, the plan has two glaring deficiencies. First, the division of responsibility between the primary federal regulators is cumbersome and could create considerable confusion: the OCC/OTS supervises state thrifts and the Federal Reserve supervises all state banks, and because the charterer who has the largest bank has jurisdiction, the FBA could also regulate state-chartered banks. What if the state-chartered bank grows to be larger than the national—do we switch regulators?

In regard to state banks and their relationship to the Federal Reserve as the federal regulator, it is not yet clear what role the Federal Reserve will play—whether it will impose its own views on what are acceptable banking activities by state-chartered institutions. Currently, the FDIC does not recognize various banking powers as inherently good or troublesome; instead, it reviews the activities to determine how the powers are used by each institution. In contrast, the Federal Reserve takes a more structured approach and works from an *a priori* list of acceptable banking powers. I suspect that clashes between state regulators and the Federal Reserve over the exercise of these state-empowered activities are inevitable, which is not altogether bad and reflects the dynamic tension that often exists between state and federal regulators. The question is: who has the ultimate veto power? At what point? By institution? By power? And should it be the state and the insurance fund who determine this or the state and the Federal Reserve?

On another matter, I question whether the new proposals, if enacted, will end up requiring state banks to pay fees to both state and federal regulatory agencies, as S&Ls must do now to the OTS. If so, this amounts to an added tax burden on state banks that places them at a disadvantage with federally chartered institutions. Add the deposit insurance premium to this and you are fast reaching a point where the proverbial straw will break the camel's back. This added tax on the state charter will ultimately pave the way for a "nationalized" banking system, an outcome that would turn the pendulum of change into a wrecking ball and lead to the demise of the dual banking system. And if state banks seek to avoid the additional tax and switch in significant numbers to a federal charter, it is difficult to predict how the primary federal regulators will pick up the supervisory slack.

We in New York State already know the difficulty of allocating re-



sources to meet a statutory mandate that requires us to examine every state-chartered domestic institution on-site once a year. We have done that and more: like carrying an additional burden for federal regulators who were forced to reduce their examination schedules in New York to address emergency situations in the southwest and New England. Under the new system, one wonders whether some banks will ever see a regulator. A few bankers may think that's a great idea, but when an examiner finally does come around after a long absence, more drastic remedies may be required because a supervisory problem was not corrected early on.

The second deficiency is that eliminating the FDIC as the primary federal regulator of state banks appears to reduce the FDIC's direct authority to protect insured deposits. The Federal Reserve and FDIC are independent agencies and the OCC is a creature of Treasury. Will that have an impact?

We saw what happened in the thrift industry when the Federal Home Loan Bank Board supervised both the chartering and insurance functions. Experience dictates the wisdom of keeping these functions separate. While both are concerned with the safety and soundness of an institution, the obligations of the chartering agency are different from those of the insurer, and it is only the healthy tension between the two that serves the best interests of a bank and its depositors.

#### D. Restrictions on State Powers

Since the latter part of the 1980s, the federal government has undertaken an aggressive program to curb the powers of state-chartered institutions, both through legislation and regulation. Late last year, for example, the FDIC proposed extending restrictions on federally insured S&Ls to state-chartered S&Ls covered under SAIF,<sup>41</sup> which was established by the authority of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (the "FIRREA").<sup>42</sup>

FIRREA did not extend to state-chartered savings banks and many S&Ls sought to convert their charters in those states that permitted this type of institution. New York is one of them; it has been chartering and supervising savings banks for 150 years and I can assure you that the powers granted to these banks have been exercised in a prudent manner. The FDIC claimed, however, that these so-called "charter flips" from an S&L to a state savings bank put the insurance fund at risk and proposed that the S&L restrictions be extended to all SAIF-insured state savings banks as well.

Because none of New York's sixty-six state-chartered savings banks are SAIF-insured—they are insured by the FDIC's BIF and follow the same regulations as do commercial banks, including capital require-

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41. See 55 Fed. Reg. 51,117 (1990).

42. Pub. L. No. 101-73, 103 Stat. 183 (1989).

ments—the rule would have no immediate impact unless the FDIC extended it to all federally insured institutions. Should that happen—and the FDIC indicates that it may—there will be several restrictions and notice requirements placed on savings banks that do not presently exist.

The biggest impact on New York savings banks would be the implicit extension of the Qualified Thrift Lender (the “QTL”) standards for S&Ls to savings banks by limiting the investments they may pursue. At the present time, savings banks have a wide range of investment authority and are not required to devote a specific part of their investments or loans to home financing.

Sharply curtailing the extent to which a savings bank may diversify its portfolio under state law raises safety and soundness concerns. From my perspective, diversity in investment and income source is the key to financial stability for all depository institutions, a diversity that would clearly be lessened for New York savings banks under the FDIC proposal. This diversity, coupled with vigilant supervision, has enabled New York savings banks to enjoy a broad scope of powers while keeping investments at safe and prudent levels.

It is the imprudent use of a power by a financial institution that causes problems for regulators, not any inherent risk associated with any particular power. While there have been problems at institutions chartered by some states, the problems have been fewer than among federally chartered institutions according to Senate Banking Committee data, which reported that the failure rate was seven percent for national banks, compared with four percent for state banks from 1987 through 1990.<sup>43</sup> These statistics suggest that not only is the blanket usurpation of state regulation both radical and unnecessary, it may even be dangerous.

The new Treasury proposal also recommends prohibiting direct equity investment in real estate and other commercial ventures—already prohibited for national banks—for federally insured state banks as well.<sup>44</sup> Federally insured state-chartered banks would generally be prohibited from engaging in activities not permitted for national banks unless the state bank is fully capitalized and the FDIC finds that the activities do not create a substantial risk of loss to the insurance fund. It also appears that this effort to force state banks to comply with federal regulatory limits is gaining considerable support in both houses of Congress.<sup>45</sup>

In principle, all of these proposals collide head-on with the established rights of states to grant banking powers that benefit their local communities. These powers to make direct real estate equity investments, to sell insurance, to buy and sell securities, and to underwrite government and corporate securities and commercial paper are not granted irresponsibly. They are enacted by state legislatures and regulated by state banking de-

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43. See *Wall St. J.*, Feb. 8, 1991, at A4, col. 1.

44. See *Treasury Reform Proposal*, pt. one, subpt. V, at 46-48.

45. See H.R. 6, 102d Cong., 1st Sess. (1991); S. 3103, 102d Cong., 1st Sess. (1991).

partments because they are vital to a state's economic interests. It is important that federal preemption of state legislated prerogatives be well considered and occur only after a substantial showing of necessity. Even now, the FDIC plays a significant role in preventing excesses in the use of state powers, but it does so by moderating rather than attempting to prohibit the exercise of the state power on the basis of some formula or legal constraint.

Powers granted at the state level can be beneficial and attract new business even if they contribute only indirectly to the bottom line. Back in the early 1980s, when New York had its own thrift crisis, when the cost of savings bank deposits exceeded income from assets, the fee income generated from state-empowered subsidiary businesses provided positive cash flow. Yet when institutions were brought into a holding company structure as stand-alone thrifts, it was powers like Savings Bank Life Insurance (the "SBLI")—the ability of savings banks in the northeast to act as agents or underwriters of life insurance—that were part of the divestiture "agreements" with the Federal Reserve. On what grounds? Safety and soundness? Lack of profitability? Experience? The New York State Banking Department has been successfully supervising SBLI for the past fifty-one years, and our supervisory history goes back 162 years.

#### CONCLUSION

There are many, of course, who argue that Congress should establish, once and for all, a "nationalized" banking system with uniform powers, regulations and supervisory requirements at the federal level. The idea looks good on paper; it is neat and tidy; it sounds fair; it even appears manageable.

But given the interests of our states and our various banking organizations, any nationalized banking system would inevitably be a committee effort, based on a least common denominator factor, and fixing standards and regulations that may be far more than needed in a state with few financial institutions but totally insufficient for financial institutions in New York or Illinois or California.

If our experiences with the thrift crisis and its spillover into commercial banking have taught us anything, they should warn us not to legislate detailed prescriptions on products and activities ever again. Rather, we should construct a safe but flexible regulatory and supervisory framework within which all of our financial institutions—state or national, commercial or thrift—can respond to market changes.

Over the remainder of this decade, there will truly be a transfiguration in our banking system. This will include changes in the way it will be organized and regulated, changes in powers, changes that may unfortunately presage the final shift of economic power from the states to Washington. Too heavy a hand at the federal level could well create a massive

and top-heavy banking system unable to respond quickly to changing market conditions.

Unlike the highly centralized banking systems in Europe and elsewhere, the American banking system—if indeed it can even be called a system—reflects the vast differences that exist among the states, the diversity of its peoples and the nation's political structure with the checks and balances inherent in a federal system.

I believe all of us are aware of the economic problems experienced by our banking system. The competitiveness and strength of the traditional bank franchise has been eroded because outdated laws prevent banks from responding to market forces by entering new lines of business and achieving geographic diversification; traditional lending opportunities have decreased and changes in the marketplace have allowed others who are not similarly regulated to erode the banking industry's franchise.

On the regulatory side, major legislative and regulatory changes did not keep pace with market changes, causing hardship to financial institutions that suffered from diminishing capital, particularly in the thrift category. And the advent of deregulation, without a concomitant expansion of supervision, created a marketplace vacuum that was all too often exploited by incompetent or unscrupulous managers and entrepreneurs.

Reform is necessary, even vital, but if it comes by preemptive strike, by fiat rather than enabling legislation, it will destroy the basic strength of our dual banking system—the ability of states to act as laboratories for change, the very thing President Bush addressed so eloquently in his State of the Union message.

It was the dual banking system that permitted state-regulated banks to develop marketing innovations, many of which are now integral parts of our banking system. It was the dual banking system that established our state banks as laboratories for change, with flexibility to respond effectively to local conditions.

One hopes that reason will ultimately prevail and that what emerges from Congress will combine the virtues and flexibility of state regulation with added banking powers, thus enabling our banks to function nationwide under an efficient federal regulatory system.

For the United States to remain a strong and vital market, it needs a strong and vital financial system. It must be a system that is characterized by a realistic appreciation of the legitimate objectives of banks in a competitive environment. And it must recognize the importance of an open regulatory structure that fosters creative and safe and sound innovation in products and services.

