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THE BENEFITS OF CHARTER CHOICE THE DUAL BANKING SYSTEM AS A CASE STUDY

The United States has the strongest and most innovative banking system in the world, in large part because banks have the choice of being chartered by the state or federal government. This choice creates a healthy dynamic tension among regulators, resulting in a wider range of products and services available to consumers, lower regulatory costs, and more effective, more responsive supervision.

Dual chartering of banks has over a 140-year history in our nation. It was in 1863, after 80 years of solely state regulation, that the federal government began chartering and regulating banks. The National Bank Act signed that year did not replace the state system, as many people expected. It offered banks the choice of having a state or national charter.

Simply put, dual chartering in banking has strengthened the state charter, fostered innovation in financial products, and enhanced financial supervision.

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The establishment of the federal banking charter in the 1860s has strengthened the state charter, forcing the states to continually improve the charter. The “death” of the dual banking system has been forecasted on many different occasions, yet dual chartering continues to thrive.

For example, in the 1800s, each state bank had the authority to issue its own currency in the form of bank notes. To discourage the issuance of state bank notes and to promote a uniform currency, the federal government imposed an annual 10 percent tax on such notes in 1864. Some believed that state note taxation would end the states’ experimentation in regulating banks. However, these expectations were wrong. The state bank response was to develop the checking account – still the dominant means of making payments almost 140 years after its inception.

Federal Reserve Board Chairman Alan Greenspan, reflecting on this piece of banking history, noted the continued strength of the state charter:

Any forecast at that time would quite reasonably have concluded that state banks would become historic relics. Such a projection, however, would have been quite wrong, beginning what has become an unending stream of such erroneous forecasts about the demise of state banks. Forced to find a substitute for notes, state banks

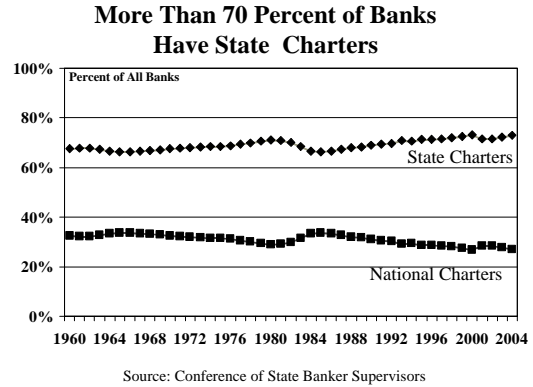
"Diversity increases the chances that innovative approaches to policy problems will emerge... A sole regulator, not subject to challenge from other agencies, might tend to become entrenched, conservative, and shortsighted."¹

U.S. Treasury
Department

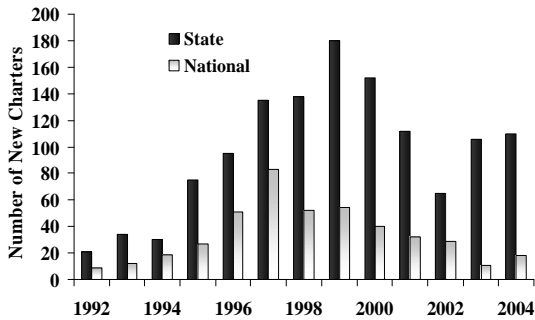


pioneered demand deposits. Within ten years after the note tax, state banks had more deposits than national banks – a lead maintained until 1943. By 1888, only 20 years after the low point, there were more state banks than national banks (approximately 3,500 vs. 3,100), a lead maintained to this day.²

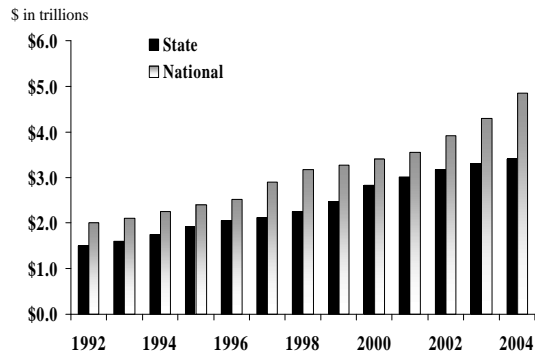
Today, over 70 percent of commercial banks operate under the state charter. “I cannot overemphasize the benefits of the dual banking system,” said former FDIC Chairman William Isaac. “The history of banking in this country reveals ebbs and flows in the attractiveness and dominance of the state-chartered and nationally-chartered banking systems, as the respective legislative and regulatory bodies were more or less responsive to changing conditions in the industry.”³



New Charters of National vs. State Banks



Assets of State vs. National Bank Charters



State-chartered banks are on average smaller than their national bank counterparts. However, this should not connote fear that state banks will be dominated by national banks. Among the 100 largest commercial banks, 48 have state charters. Ultimately, the business model employed by the commercial bank best determines the selection of charter type.



Dual chartering fosters innovation in financial products.

*For over a century, allowing charter choice has compelled state and federal regulators to continually improve the characteristics of their charters, leading to the current wide array of products and services available to consumers. As Federal Reserve Board Governor Mark Olson said, “I believe that the ability of banks to choose their regulator has fostered both the continued competitiveness of the industry and the vitality of the economic activity it finances.”*⁴

Many bank products and services that now seem commonplace evolved as a result of the regulatory competition fostered by the dual banking system. Innovations like variable rate mortgages, home equity loans, and interest-bearing transaction accounts, even the checking account, first appeared in banks under the jurisdiction of state regulators. Through initiatives of federal regulators, banks have been able to sell annuities, expand securities and mutual fund activities, and certify the security of Internet transactions – all to the benefit of bank customers.

“Now that interstate banking is a reality, I submit that the dual banking system remains an important factor underlying the strength and flexibility of our financial system.”

Federal Reserve Board
Governor Mark Olson

Studies have actually argued that not having both federal and state charters in banking would inhibit financial services competition and its benefits for consumers. A 1986 study, for instance, concluded, “the dual banking system [has] mitigated the tendency of regulators to stifle innovation and restrict new entrants.”⁵

Dual chartering fosters better financial supervision.

Providing a choice between regulators gives a broad perspective and guards against rigidity.

This regulatory flexibility is important in maintaining bank competitiveness in this era of financial modernization, where banks, securities firms and insurance companies are combining operations under a single financial holding company. According to Professor Edward Kane, “... overlapping federal and state regulators looks in the short-run like wasteful duplication; but leads in the long-run to better-adapted regulatory rules.”⁶

Some observers have argued that dual chartering reduces the attentiveness of regulators to safety and soundness issues. This has not been the case with banking. To the contrary, regulatory choice provides important checks and balances.



Permitting financial institutions a choice of charter forces regulators to update and improve examination techniques and examiner training, lest supervised institutions abandon them out of frustration. Regulators are forced to maximize efficiency. If a regulator does not control costs, institutions may shift charters to escape exorbitant supervisory fees. Moreover, regulatory authorities are encouraged to take a healthier, more positive posture on financial innovation and risk-taking when there are charter alternatives.

Regulatory choice drives down costs and increases the speed with which new products and services are developed. Federal Reserve Chairman Alan Greenspan agrees: “Banking supervision and regulation can only benefit from the variety of viewpoints and checks and balances of a system of more than one regulatory authority. A system in which banks have choices, and in which regulations result from the give and take involving more than one agency, stands a better chance of avoiding the extremes of supervision... A single regulator, charged with responsibility for safety and soundness, is likely to have a tendency to suppress risk taking. A system of multiple supervisors and regulators creates checks on this propensity.”⁸

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Federal Reserve
Chairman Alan
Greenspan

An equally important strength of the dual system according to Isaac, is that it "embodies a system of checks and balances between two levels of government and helps to ensure the decentralization of decision-making power. It serves as a safety valve against concentration of power in the hands of a few decision-makers, who can become imperceptive or complacent, and against the potential for abusive or simply unwise actions."⁹

This decentralization of decision-making in bank regulation has created an environment where state and federal legislative bodies and banking regulators must work together on regulatory and other policy matters that enhance financial supervision. There are many examples of state-federal cooperation. State and federal legislative bodies worked together to form the basis for first regional and then nationwide interstate banking. State-federal regulatory working groups operate across the nation on an ongoing basis to detect and deter bank fraud and share regulatory findings. Other examples include the development of consistent bank supervisory examination reports across state and federal bank regulatory agencies. State and federal agencies also accept each other's examination reports as if they were their own, and share examination report software and other technology, reducing the potential duplication of effort that could occur if there was not a high level of cooperation between them.

Conclusion: Dual chartering works.

The bottom line is that dual chartering works. It has strengthened the state charter, forcing the states to improve the charter in order to remain competitive. It also has fostered innovation in financial products, leading to the current wide array of products and services currently available



to consumers. And, it has led to better financial supervision by providing a variety of viewpoints and checks and balances in our system of financial regulation.

Chairman Greenspan has argued that the absence of the dual system could actually hurt consumers, and the economy: “when there is no choice of regulatory agency, rigid policies and interfering regulatory micro-management can develop.”¹⁰

The alternative to dual chartering is thus potentially poorer services and less financial support for consumers, businesses, and ultimately, the national economy.

¹ U.S. Department of the Treasury, *Modernizing the Financial System*, February 1991, page XIX-6.

² Alan Greenspan. *Our Banking History*. Annual Meeting and Conference of the Conference of State Bank Supervisors, Nashville, TN, May 2, 1998.

³ William M. Isaac, Director, FDIC, “Address to the 79th Annual Convention of the Conference of State Bank Supervisors,” April 28, 1980.

⁴ Mark Olson, Governor, Federal Reserve Board, “The Dual Banking System and the Current Condition of the Banking Industry,” (Address to the Conference of State Bank Supervisors, May 31, 2002.

⁵ *E.g.*, George Benston, Robert Eisenbeis, Paul Horvitz, Edward Kane and George Kaufman, *Perspectives on Safe and Sound Banking*, 1986, page 277.

⁶ Edward Kane, The James Cleary Professor in Finance at Boston College, “Technological and Regulatory Forces in the Developing Fusion of Financial-Services Competition,” *Journal of Finance* 39(3), July 1984, 759-773.

⁷ Alan Greenspan, “No Single Regulator for Banks,” *Wall Street Journal*, December 15, 1993.

⁸ Alan Greenspan, “No Single Regulator for Banks,” *Wall Street Journal*, December 15, 1993. *See also*, U.S. Department of the Treasury, *Modernizing the Financial System*, February 1991, page XIX-6 (arguing that a multiplicity of regulators brings broader perspective to financial services regulation. According to the study “the existence of fewer agencies would concentrate regulatory power in the remaining ones, raising the danger of arbitrary or inflexible behavior. . . . Agency pluralism, on the other hand, may be useful, since it can bring to bear on general bank supervision the different perspectives and experiences of each regulator, and it subjects each one, where consultation and coordination are required, to the checks and balances of the others' opinion.).

⁹ William M. Isaac, Director, FDIC, “Address to the 79th Annual Convention of the Conference of State Bank Supervisors,” April 28, 1980.

¹⁰ *E.g.*, *BNA Banking Report*, March 7, 1994 (Greenspan arguing that having no alternatives in financial regulation can hurt financial consumers and the economy).

