

## Perspectives on 150 Years of Dual Banking

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Conference of State Bank Supervisors  
State-Federal Supervisory Forum  
Savannah, Ga.  
May 22, 2012

The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

It is a pleasure to be with you today. I have been coming to these meetings for a number of years, and I have always appreciated that key supervisory issues that are highly relevant to all of our agencies are consistently highlighted on the agenda. This forum provides a unique opportunity for the state and federal agencies to share views and to learn from one another. In addition, this year's agenda has broadened the forum to include not only state supervisors and their federal counterparts, but also the Office of the Comptroller of the Currency as regulator of federal charters and the new Consumer Financial Protection Bureau.

Some have questioned whether this diversity of regulators and views can be effective in today's global financial market and whether the current regulatory structure is outdated and inefficient. Over the years, various reforms have been proposed to improve efficiency and effectiveness by removing diversity. Even so, the dual banking system in the United States has remained firmly anchored in the modern world of banking and finance. And over the past 150 years, financial markets in the United States have developed into world-class centers of capital and have led financial innovation.

Can this diverse regulatory model serve us well in the next century and allow the United States to maintain a strong, efficient and innovative banking system? Does an increasingly concentrated banking industry demand fewer regulators? Let me explain why I think this structure has not only survived for 150 years but has proven to be so durable and responsive to our dynamic economy. And what will it take for the system to remain relevant going forward?

### Development and Growth of the U.S. Banking System

The United States' economy has benefitted tremendously from a diverse banking system that provided the means for efficiently allocating capital from savers to borrowers. Thousands of

state-chartered and federal-chartered financial institutions, most of which are small community banks, allow credit to flow to individuals and businesses, even in remote areas of our country.

The dual banking system owes its beginnings to the introduction of federally chartered banks with the passage of the National Bank Act of 1864. Prior to that, commercial banks were initially organized under charters granted by state legislatures—a process that became highly politicized. The next step was states' instituting free banking laws, which allowed anyone to open a bank as long as they could meet the standards specified in a state's banking laws. Then came the National Bank Act. While the primary motivation for this act appears to have been to help finance the Civil War, the act's basic provisions mirrored key aspects of the free banking laws that states had adopted—specifically free entry and flexibility to adapt to a changing economy. Thus began the competition between state and national bank charters and the emergence of a dual banking system.

A report on the dual banking system prepared by the Federal Reserve in 1930 makes it clear that this system was not intentional. Rather, as the report claims, it was expected that the introduction of a federal charter and a subsequent tax on state bank notes would incent bankers to convert to federal charters. The Fed's 1930 report raised a number of questions about the need for such a structure and noted various issues with advantages of one charter over the other. Concerns were expressed about the quality of state bank supervision—not unlike the 2012 study to be presented tomorrow. However, I firmly believe that we have a stronger supervisory system—both at the state and federal levels—as a result of dual banking.

## Innovation and Improvement through the Dual Banking System

The dual banking system has provided and continues to offer significant benefits to our financial system and the economy. One of the primary benefits of dual banking is that the multiple options for state and federal charters have led to considerable innovation and improvement in banking services. We have seen these benefits from the beginning.

For example, it has allowed local bankers, state supervisors and state governments to construct a banking system closely attuned to the economic needs of each state and supervised by personnel with a strong knowledge of the structure and condition of the local economy. State legislatures and supervisors have a long history of adopting their own set of prudential laws and regulations, consumer protection statutes, and bank chartering and expansion laws—all of which generally reflect the needs of each state.

A second example occurred soon after the national banking system was established. While the National Bank Act created greater competition for state chartering authorities and state banks, the playing field became steeply tilted against state banks in 1865 when the act was amended to tax the issuance of state bank notes. As you would expect, this competitive disadvantage led to a sharp decline in state banks from about 1,500 in 1864 to about 250 in 1868, whereas the number of national banks rose to about 1,650.

Certainly these reforms must have portended the end of state-chartered banking. But state banks were able to overcome this uneven playing field and demonstrate their resilience by taking advantage of the growing importance of demand deposits and the significant benefits they offered compared to bank notes. Within 10 years after the note tax, state banks had more deposits than national banks, and within 25 years, there were more state banks (about 3,500) than national banks (about 3,100).

Since then, a number of innovations resulted from changes in state banking laws. Most notably, we've seen the development of NOW accounts, adjustable rate mortgages, home equity loans, and interstate banking through the use of regional compacts and nationwide entry laws prior to the eventual passage of national interstate banking.

### Choice of Regulators

Another benefit of the dual banking system is that the option to choose a regulator has made bank supervision and regulation much stronger and more efficient. When the National Bank Act was passed, the choice was between a state banking regulator and the OCC. Since then, the choice has expanded further with the addition of the Federal Reserve and Federal Deposit Insurance Corp. as federal regulatory options for state banks. In fact, the choice is even greater today because interstate banking allows state banks to choose among state banking authorities.

Critics of the dual banking system and the regulatory structure often claim that providing banks a choice of regulator reduces bank safety and soundness and the stability of the financial system by creating a "race to the bottom." Regulatory choice, they say, leads to regulatory laxity as regulators compete among themselves for larger portfolios of supervised institutions.

This is an argument without merit, in my view. I have never seen this among the bank regulators in my 30 years at the Federal Reserve. In fact, I find it to be a strange argument, especially when made by economists, because competition is the process that makes market economies efficient. Choice among regulators provides an important incentive to improve examination processes and ensures examiners have timely training.

Indeed, I would argue that providing banks regulatory choice serves as a check and balance on supervisory authorities so that they are not so restrictive that banks are unable to provide the credit necessary for economic growth. Importantly, I've seen no evidence that other regulatory structures, including single regulator models, fared better in the most recent crisis.

### Preserving the Dual Banking System

Yet if the dual banking system is to serve us well going forward, we must be willing to make adjustments that adapt to a changing financial sector. One challenge is in providing states with enough leeway to continue to implement laws and supervise banks in a manner most conducive to local interests and the state economy. Federal laws have continued to expand in an effort to create a more consistent framework across all banks—both state and national. While much of this is necessary in a nationwide banking system, we must be careful to strike the right balance in limiting the preemption of state laws and in respecting the authority of state supervisors and legislators. If we fail to achieve this balance, we risk losing many important benefits of the dual banking system.

In my view, another critical challenge is making sure that supervision and regulation are consistent across regulatory agencies and over time, as well as appropriately calibrated to a bank's business model, activities and complexity.

There are many examples of coordination and cooperation. The Federal Financial Institutions Examination Council is clearly an important forum for coordination and cooperation among the state and federal agencies. State and federal agencies also accept each other's exam reports and share exam report software. Also, the Conference of State Bank Supervisors, state

banking agencies, the FDIC and the Federal Reserve cooperated closely in setting up the protocol for the seamless supervision of state banks operating on an interstate basis.

We've been successful, although it has not always been easy, in working across agencies to discuss, debate and develop joint notices of proposed rulemakings and to finalize rules. If we are to achieve our common goal of well-managed, well-capitalized and well-supervised banks, we will need to redouble our efforts to work together in this way.

In closing, it is clear to me that the dual banking system has benefited the U.S. banking system and the overall economy since its establishment nearly 150 years ago. The diversity provided by this system allowed our economy to grow and to be the most vibrant, innovative and strongest in the world. This system has served the country well for many years, and I believe with the commitment of those here today it is a system that can continue to serve the public interest and responsibly promote economic growth for years to come.