Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 2, 1994.

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I am pleased to appear today before the Senate Banking Committee to give the views of the Federal Reserve Board on proposals to consolidate the banking regulators into a single agency. We have prepared a detailed analysis of such proposals, which I have attached to my statement.(1) My remarks this morning will highlight that analysis.

The proposals to create one federal bank regulator have the clearly stated objectives of reducing the government's costs of regulating and supervising banks, of reducing bankers' costs and burdens from duplicative examination and overlapping supervision, and in general making the supervisory process more efficient and more accountable. The Federal Reserve Board shares these goals but disagrees with the approach of one regulator for achieving these objectives. However, the Board believes that it is possible to achieve virtually all these proposals' objectives without creating the risks of one regulator that so trouble us.

In reaching this conclusion, the Board tested various proposals against the fundamental principle that the purpose of regulation is to enhance the capability of the regulated entity to contribute effectively to the nation's long-term economic growth and stability. We have concluded that for this to be accomplished, the following four subsidiary principles must be achieved:

* First, there should not be a single monolithic federal regulator.

* Second, every bank should have a choice of federal regulator.

* Third, there should be only one federal regulator for all the depository institutions in any single banking organization.

* Fourth, the U.S. central bank should continue to have its essential hands-on involvement in supervision and regulation.

A consolidated single regulator would deprive our regulatory structure of what the Board

considers to be the current invaluable restraint on any one regulator conducting inflexible, excessively rigid policies. Laws on bank regulation and supervision must be drawn very generally, leaving the specifics to agency rulemaking. This vests the agencies with a broad mandate and a not inconsiderable amount of discretionary power. Hence, a safety valve is vitally needed to avoid the exercise of arbitrary actions. A denial of, or severe limitation of, charter choice closes off a safety valve, inevitably leading to greater micromanagement of banks and a lessened market for bank credit. We must avoid a regulatory structure that inhibits economic growth.

The current structure provides banks with a method--albeit one neither easily accomplished nor often taken--of shifting their regulator, an effective test that provides a limit on the arbitrary position or excessively rigid posture of any one regulator. The pressure of a potential loss of institutions has inhibited excessive regulation and acted as a countervailing force to the bias of a regulatory agency to overregulate.

The dual banking system and multiple federal regulators have facilitated diversity, inventiveness, and flexibility in our banking system, so important to a market economy subject to rapid change. A single federal regulator would effectively end the dual banking system: It would become an empty shell if a state-chartered entity had no choice of federal regulator or--reflecting a recent Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) provision--different asset powers. The dual banking system cannot survice consolidation at the federal level. I, as well as my colleagues on the Board, believe that would be a tragic loss.

Besides the effective loss of the dual banking system, the single regulator contemplated in current proposals would be disconnected from broad economic policy issues. This is a problem because a regulator that does not have macro-economic responsibility for its actions is likely to inhibit prudent risk-taking by banks, thus limiting economic growth and stability. The central historic purpose of banking is to take risks through the extension of loans to businesses and others. Economic growth in our system could not occur without risk-taking by entrepreneurs and small and large businesses. Risk-taking requires financing. Thus, either an unwillingness or an inability of lenders to take risks would slow the expansion of our nation's employment and income. This fact creates a significant policy trade-off in banking regulation, especially because of the government guarantee of bank deposits. On the one hand, regulators are concerned about bank failures and their effects on the economy, as well as their cost to the insurance fund. On the other hand, banks need to take risks to finance growth. Tradeoffs are required, and a swing in either direction can create both short- and long-term problems.

Indeed, a single regulator with a narrow view of safety and soundness and with no responsibility for the macroeconomic implications of its decisions would inevitably have a long-term bias against risk-taking and innovation. It receives no plaudits for contributing to economic growth through facilitating prudent risk-taking, but it is severely criticized for too many bank failures. The incentives are clear.

The Federal Reserve's stabilization objectives cause us to seek to avoid either excessive tightness or ease in our supervisory posture. The former leads inevitably to credit crunches, and the latter to credit policies that contribute, with a lag, to bank losses and failures. This is not to say, as some have advocated, that the Federal Reserve itself should be the only regulator. A single-regulator Federal Reserve would be prone to arbitrary and

capricious behavior as would any other single bank regulator. We would thus oppose such an initiative, because as a single regulator we would inevitably drift to increasing day-by-day control of banking institutions, which would soon become less innovative and competitive--a severe loss to the nation.

Not only is it important that one of our regulators have macroeconomic responsibility so as to carry out the regulatory function properly, but also our central bank must continue to have hands-on involvement in supervision and regulation so as to effectively carry out its macroeconomic responsibilities. Joint responsibilities make for better supervisory and monetary policy than would result from either a supervisor divorced from economic responsibilities or a macroeconomic policymaker not involved in the review of individual bank's operations. Without the hands-on experience of regulation and supervision, and the exposure to the operations of banks and markets provided by such experience, the Federal Reserve's essential knowledge base would atrophy. Its deliberations would become increasingly academic, and the nation's central bank would soon resemble an ivory tower rather than an institution necessarily involved with the day-to-day activities of our economic and financial system. It is our knowledgeable examiners and supervisors--knowledgeable about banks, financial markets, and the payment systems that connect them--that provide the expertise the Federal Reserve needs. And the fact is that we simply could not retain such staff members if they were not actively involved in the process; reading reports or joining as junior participants in a handful of examinations would not be sufficient.

Some have argued that most foreign central banks are not involved in bank supervision and regulation. In fact, as described in more detail in the attachment, central banks in all but one Group of Seven (G-7) country (Canada), in most cases de jure but always de factor, are closely involved with the supervision of banks in their countries and internationally. More broadly, the central bank has either total or shared responsibility for bank supervision in three-quarters of the nations in the Organization for Economic Cooperation and Development (OECD). One example that is frequently used by those who believe that central banks in foreign countries are not involved in supervision is the Bundesbank. The facts show quite the contrary: The Bundesbank has more supervisory staff than the German Federal Banking Supervisory Office, reviews the auditors' reports before the Banking Supervisory Office receives them, and has veto power over certain liquidity and capital regulations of that office. In all industrial countries, either central banks or finance ministries, or both, are involved with supervision because nations have come to understand that bank supervision has economic consequences that are important for stability and economic growth.

Removing the Federal Reserve from supervision and regulation would greatly reduce our ability to forestall financial crises and to manage a crisis once it occurs. In a crisis, the Federal Reserve could always flood the market with liquidity through open market operations and discount window loans. But while rapid creation of liquidity is often a necessary response to a crisis, responsibilities for supervision and regulation give the Federal Reserve insight and the authority to use less blunt and more precisely calibrated techniques to manage such crises and, more important, to avoid them. The use of such technques requires both the clout that comes with supervision and regulation and the understanding of the linkages between supervision and regulation and macroeconomic growth and stability.

The Federal Reserve is required to play the key role when systemic breakdown threatens. The attachment to my statement provides some detail about Federal Reserve involvement in financial crises over the past decade. I request that as you review it, you consider certain key questions.

Could the Federal Reserve without supervisory responsibilities have successfully managed the Mexican debt crisis of 1982, the 1985 collapse of privately insured thrift institutions in Ohio and Maryland, the stock market crash of 1987, or the Drexel failure of 1990?

Would the banking community have been persuaded to respond as they did in each of these cases by a central bank with much more limited authorities to affect events? Would the Federal Reserve without supervisory knowledge or authority have been able to play a role in persuading many of the banks to complete the payments necessary to prevent payments gridlock?

Finally, would a single bank regulator with no macroeconomic stabilization responsibilities have given the proper weights to financial market stability and economic growth? Without market expertise, would such a regulator have recognized early enough many of the problems central to resolution of these crises?

In my judgment, the risk that the answer to all these questions is "no" is too great to take.

There are ways, short of the creation of a single agency, to address the problems in the current regulatory structure and to reduce the costs of regulations. The crux of the issue is duplicative examinations of banks. This problem could be eliminated by a regulatory system that maintained two federal regulators but provided that in general only one of these regulators supervised all the depository institutions in any banking organization.

While there are many ways to achieve an improved regulatory structure, one such approach supported by the Federal Reserve Board that could be implemented with a relatively modest series of reforms would contain the following provisions:

* Merge the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS). This organization would become the Federal Banking Commission.

* Remove the Federal Deposit Insurance Corporation (FDIC) from examining healthy institutions.

* Put all independent national banks, all lead national banks that are part of a holding company, and all thrift institutions under the purview of the Federal Banking Commission, and put all independent state banks and all lead state banks that are part of a holding company under the purview of the Federal Reserve.

* Provide that the supervisor of the lead depository in a banking organization also be the supervisor and regulator of all the depository institutions in the organization regardless of the charter class of those affiliates.

* Finally, treat all U.S. activities of foreign banks as now, with adjustments as necessary to reflect the changes in the regulatory structure described above.

The Board has not yet adopted a position on the supervision and regulation of bank holding companies and their nonbank affiliates. The following are two broad options, and a strong case can be made for each:

* Under the first option, all holding companies and their nonbank affiliates could remain under the Federal Reserve's jurisdiction, continuing to provide uniform rulemaking for competitive equity and a substantial role for the Federal Reserve in shaping the financial structure, so useful for stabilization and systemic risk purposes.

* Under the second option, the jurisdiction of virtually all holding companies could be split between the Federal Reserve and the proposed Federal Banking Commission on the basis of the charter class of the lead bank. However, for systemic risk reasons, jurisdiction over the holding companies and nonbank affiliates of a modest number of banking organizations that meet certain criteria--such as large size and payment and foreign activity--would be retained by the Federal Reserve even if the lead bank of the organization had a national charter.

Under either option, the number of banking organizations subject to multiple regulators would drop sharply.

Whichever holding company option is selected, the general proposal would have the Federal Reserve supervise and regulate state nonmembers, with these banks being a significant addition to our existing regulatory load. This expansion of the Federal Reserve's supervisory functions rests solely on the notion that in a two-agency structure it is desirable to have responsibility for supervision and regulation defined clearly by charter class to preserve the dual banking system. The Board makes no case that responsibility for such banks--which account for almost one-quarter of bank assets--is needed for financial stability and monetary policy purposes. However, responsibility over banks of various sizes and locations, as under our existing authorities, is required if the Federal Reserve is to perform its functions effectively.

The Board's approach would achieve essentially all the benefits of one consolidated regulator while incurring virtually none of its risks. It eliminates duplicate supervision of depositories in a single banking organization and greatly reduces overlapping regulation. It maintains the dual banking system and permits any bank to change federal regulator by changing charter, thus ensuring a set of checks and balances on the arbitrariness of a single regulator. It maintains the healthy process of dynamic tension in bank rulemaking. It maintains the practical knowledge and skill, and the influence and authority, of the central bank, so critical for crisis prevention, crisis management, and monetary policy. It maintains the valuable perspective the central bank brings to supervision. In short, the proposal would avoid an inflexible, single regulator, preserve the dual banking system, ensure that an economic perspective is brough to supervision and regulation, and maintain a strong central bank.

(1.) The attachment to this statement is available from Publications Services, Board of Governors of the Federal Reserve System, Washington, DC 20551.

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