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The independence of bank supervision is not likely to find its way on to the list of America's great contributions to popular government. But given what we increasingly know about the vital role that independent supervision plays in maintaining financial stability, it may be time for a new list. The importance of supervisory independence -- and what we must do to keep U.S. supervision effective and independent -- are the subjects I'd like to discuss with you this afternoon.

Certainly the subject has a long history. In 1829, when New York State legislators created the nation's first truly professional bank supervisory agency, they took steps to ensure that it would be able to operate free of political influences and pressures. So did the legislators who created the national banking system in the 1860s. They created the Office of the Comptroller of the Currency as a "separate bureau" within the Treasury Department. They provided the Comptroller with a five-year term and protections against premature removal from office. The first bill that passed Congress forbade the Comptroller's removal except with the approval of the Senate -- an extraordinary requirement. But in amended legislation, that "advice and consent" requirement was dropped -- not because of second thoughts about the importance of protecting the Comptroller's independence, but in recognition of the practical difficulty of reassembling a recessed Senate -- in those days, the Senate was not in virtually continuous session, as it is today -- to deal with a Comptroller whose conduct merited removal. Indeed, the Senate recognized "the force of the argument that [the Comptroller] ought to be in a great degree independent."

Congress even contemplated moving the OCC to New York or Philadelphia, so the Comptroller would not have to contend with the bleating and pleading of the lobbyist crowd. And the founders of the national banking system expressed their commitment to supervisory independence when they chose to fund the examination of national banks from fees and assessments on the banks themselves, rather than entangling the OCC's performance of bank supervision in the political give-and-take of the federal budget and appropriations process.

The legislative debate on the National Bank Act of 1864 may have been brief, but supervisory independence -- and how best to safeguard it -- was central to it. And the authors of that legislation took great pride in the success they believed they had achieved in promoting it.

It's important to note, moreover, that the independence of supervision is not simply an interesting bit of historical trivia. It has been reinforced repeatedly by Congress, even up to recent years. Within the past decade, for example, Congress has passed additional measures forbidding the Treasury Department from intervening in any matter or proceeding before the OCC, or from delaying or preventing the issuance of any rule or regulation by the OCC, and it has expressly permitted the agency to submit legislative recommendations and testimony to Congress without prior approval or review in the Executive Branch.

It's also important to note that this is not an issue of purely domestic relevance. Experience in other countries, where the tradition of supervisory independence may be weak or nonexistent, reminds us that there's a steep price to be paid when supervisors are unable or unwilling to conduct their business independently.

Indeed, the absence of supervisory independence has been implicated in almost every national financial crisis the world has recently seen. In Argentina, South Korea, Thailand, Japan, Turkey, and Indonesia, bank supervisors were unable to operate with the independence their responsibilities demanded. In each case, supervisors became instruments of government or central bank policies that subordinated the safety and soundness of financial institutions to other goals. In each case, banks were permitted -- or even encouraged -- to make loans in defiance of good credit practices in order to promote certain policy objectives, such as protecting inefficient industries. Moreover, in each case, the result was the same: supervision was discredited; the condition of the banking system deteriorated; the national economy suffered; and the process of recovery was seriously impeded by a crippled banking system. Some countries are still struggling with the consequences of such ill-advised supervisory policies.

These experiences help explain why, when the Basel Committee on Banking Supervision adopted its core principles for effective supervision in 1997, "operational independence and adequate resources" headed the list. And the experiences of other countries remind us of the importance of vigilance in defending supervisory independence here at home.

Supervisory independence in this country has also seen its share of challenges. During the Great Depression of the 1930s, for example, there was strong sentiment that federal bank supervisors should align themselves behind the monetary and macroeconomic policies of the Treasury Department and the Federal Reserve. Many people thought that the Comptroller of the Currency should encourage national banks to make loans to good borrowers and bad borrowers alike, and to look the other way as credit quality deteriorated. This view was frequently expressed in terms of countercyclicality -- that bank examiners ought to promote the cause of growth and easy credit when the economy was in a slump and enforce credit restraint when the economy was in danger of overheating.

Fortunately, the firewalls erected by Congress in the 1860s and buttressed over the years thereafter held strong during the banking crisis of the Great Depression. The OCC was able to continue supervising national banks objectively and independently, and the banking system subsequently regained its strength.

That experience was not lost on a generation of bank supervisors, who came away convinced that combining monetary policy and supervision would undermine both. For people like J.L. Robertson, who served as a bank supervisor for 30 years, first as a Deputy Comptroller of the Currency and then as a Governor of the Federal Reserve System, it became an article of faith that "bank examiners should never be obliged to switch from rose-colored glasses to black ones, and bank and forth again, in an effort to implement the monetary policy of the moment."

However, the notion that federal bank examiners might be pressed into service of some larger political or economic agenda lived on -- and it lives on today, after a fashion. For evidence one need look no further than the introduction to our own conference program, where, sure enough, you'll find the question whether "regulation and supervision [should] attempt to smooth the business cycle" on the list of current supervisory issues.

I believe it's a matter of considerable significance, however, that while we may still debate the idea of using bank supervision as a macroeconomic tool in forums like this one, the question has essentially been laid to rest in government circles. Indeed, it has never come up in any official discussion in which I have participated, either as Under Secretary of the Treasury for Domestic Finance or as Comptroller of the Currency. The statutory constraints that limit the ability of Treasury to become involved in matters at the OCC have been well understood and scrupulously respected during my experience in the Department. As a practical matter, I believe, the principle of operational independence for bank supervisors in this country is no longer open to question.

There's another dimension of supervisory independence -- independence from the institutions we supervise. In this regard, the chartering and regulatory choices available to U.S. banks -- the dual banking system and the tripartite division of federal regulatory responsibility -- create certain tensions. The problem was highlighted over 30 years ago by Federal Reserve Chairman Arthur Burns, who decried what he saw as a dangerous "competition in laxity," not only between state and national bank supervisors, but among the various federal regulators as well, each having an incentive to pursue supervisory and regulatory strategies that would attract constituents to their particular jurisdictions.

In the game of regulatory competition, a gain to one supervisor usually means a loss to another, with varying consequences. While it is true, for example, that a wholesale exodus of banks away from the national charter could decimate the OCC, a threat equally if not more imposing might face the Federal Reserve System if there were to be a wholesale exodus away from state member status. In such an event the Federal Reserve Banks -- already facing competitive pressures in other aspects of their operations -- could face the need to downsize significantly their role in supervision. Not only would this have implications for the Fed's monetary policy and discount window functions, but, as the Reserve Banks were forced to shrink and become less substantial participants in the financial system, it would have implications for an important foundation stone of the Fed's independence.

We have been willing for many years, in the name of federalism, to accept whatever implications the mere existence of the dual banking system might have for supervisory independence, and I am a supporter of the dual system. But there is an aspect of the dual system -- the way in which the costs of supervision are allocated -- that presents an even greater threat to the independence of bank supervisors than dual banking in and of itself -- a threat that has disproportionately serious implications for the OCC.

No one would ever accuse the United States of not taking literally the Basel principle that bank supervisors should have adequate resources at their disposal. In 2001, the total of supervisory expenditures in this country amounted to nearly two billion dollars -- a substantial sum by any standard. That covers the supervisory expenses of the OCC (for national banks), the Federal Reserve (for bank holding companies and state member banks), and FDIC (for state nonmembers), as well as the expenses of the 50 state banking authorities.

It's how we raise and allocate that vast sum that introduces irrationality into our system, that potentially undermines its safety and soundness, and that destabilizes our dual banking system. There's nothing terribly complicated about it. National banks must bear the entire cost of their supervision, in the form of assessments paid to the OCC. State banks, by contrast, receive the federal portion of their supervision -- far and away the largest component of state bank supervision -- at no cost.

To be sure, state banks pay relatively modest fees to their state supervisors, reflecting the comparatively modest role that many states play in the supervision of federally insured state banks, compared to the pervasive roles played by the Fed and the FDIC. As a consequence, national banks pay on average two and a quarter times more in supervisory fees than do state banks. While national banks fully shoulder their costs of supervision, state banks pay only about 22 percent of the costs of their supervision.

That's not all. National banks actually subsidize the supervision of their state-chartered competitors. The FDIC draws on the insurance fund to cover the expenses of supervising state nonmember banks, yet 55 percent of the balance in the fund reflects insurance premiums paid by national banks. Thus, 55 percent of the subsidy that the FDIC affords state banks by absorbing their cost of supervision is, in effect, provided by national banks. A similar subsidy is delivered by the Federal Reserve to state member banks, since the costs of Fed supervision are not passed on to the banks they supervise. In this case, however, it is taxpayers that bear the cost of the subsidy, since the funds that the Federal Reserve draws on to absorb the costs of supervision would otherwise be returned to the Treasury.

Operating in tandem, the freedom that banks have to choose a state or national charter and to choose their federal regulator, <u>and</u> the disparity in the allocation of the costs of supervision caused by the federal subsidization of state banks, create a system in which financial institutions have a potential influence in their relationships with their supervisors.

This influence can be exercised overtly or tacitly -- and, I hasten to say, it is not an influence that may be directed only at the OCC. Fee disparity simply becomes a cost factor for banks to weigh in the balance. If a bank feels "oppressed" by the OCC to the point that the combined cost of the higher fees and the supervisory "oppression" outweigh the advantages of the national charter, the bank has an incentive to convert. By the same token, if a state bank feels "oppressed," either because state law or its federal regulator limits its flexibility to conduct its business in the manner it desires, the incremental cost of higher assessments might be outweighed by the appeal of the national charter.

Fee disparity can have a particularly insidious impact on the OCC, however, because, unlike our self-funded sister agencies, we must tax our bankers to maintain our agency. Thus, to the extent fee disparity encourages conversions to state charter, there is a direct impact on the OCC's budget. In times of severe stress in the economy, this impact could have serious consequences. As a deteriorating economy translated into increased problems for banks, supervisors would be confronted with the need to expand their resources to cope with worsening conditions. At the OCC this would likely create a need for increased assessments -- with a commensurate increase in the financial burden on national banks. Those national banks in the best condition, facing the prospect of larger assessments needed to deal with problem institutions, would thus have a strong incentive to convert to the subsidized state charter, leaving a diminishing number of national banks to bear the costs of an increasing OCC workload. And of course such conversions do not change at all the systemic costs of supervision, since the agencies assuming jurisdiction must pick up the costs of expanding their own supervisory resources to deal with the converted banks. Conversions thus simply transfer those costs from the national banks to either taxpayers generally or to all insured banks. The implications for the independence of the OCC in such a scenario are self-evident, I believe.

I'm encouraged to see that there's a growing understanding of these issues, and a consensus that the problems I've been discussing are problems that must be fixed. The question, of course, is how we should do that. Any solution we propose must meet several basic criteria. First and foremost, it should protect and preserve the independence of bank supervisors. It must also make our system of supervisory funding fairer, more secure, and more predictable. National banks should not be forced to subsidize their state-chartered competitors and taxpayers should not be expected to defray the cost of supervising one favored class of banks, as is now the case with state member banks that receive free supervision from the Federal Reserve.

Both state supervisors and the OCC must be freed from the uncertainty that currently surrounds their funding. At present, we are subject not only to fluctuations in the economy, but to changes in the structure of the banking system. Declining on-balance sheet assets mean declining revenues. And industry consolidation means an increasing reliance on a shrinking number of institutions. In half the states, a single bank accounts for 25 percent or more of the asset base on which state supervisors assess fees. The loss of such a large bank, through either failure or conversion, could have a crippling effect on a state supervisor's ability to provide quality supervision. Of course, the OCC could find itself in the same fix.

One suggestion made recently was that the OCC's funding concerns should be addressed through the use of appropriated funds. But if this means subjecting the supervision of national banks to the budget and appropriations process, it would clearly be a step in the wrong direction.

As I described earlier, since the very inception of the national banking system Congress has scrupulously insulated bank supervision from the political process -- just as it has the formulation and execution of monetary policy. Injecting political considerations into supervision through the appropriations process would clearly run the risk of bringing to bear pressures that could undermine the objectivity and integrity of the critically important work that supervisors perform, and would make the direction and strength of supervision subject to the varying priorities of partisan politics. That would be no more desirable in the area of bank supervision than in respect of monetary policy.

Certainly, if there were any serious case for subjecting bank supervision to the kind of political oversight involved in the budget and appropriations process -- and I see none whatsoever -- it would be impossible to rationalize treating only national banks in this fashion, while leaving federal supervision of state banks to be self-funded through the use of the Federal Reserve's earnings and the FDIC insurance fund, with no outside oversight whatsoever.

Of course, the funding of supervision could be rationalized in the context of legislation reforming the entire structure of federal supervision of financial institutions -- a challenge that has repeatedly been taken up over the past three or four decades.

Experience in the United Kingdom and other countries that have altered their supervisory structures suggests that serious structural change is not an impossible goal. Nonetheless, past efforts in the United States have foundered for at least four reasons:

- First, the states have always felt that if there were a monolithic federal regulator for all banks, the attractiveness of the state charter would diminish. Now state banks can choose between the Fed and the FDIC as their federal regulator, or they can choose to go to a national charter. Those options would be lost under any proposal that sought to unify supervision.
- Second, a key element of past proposals has generally been to take the Fed out of bank supervision. This aspect of restructuring has had to confront two major objections: the explicit objection that removing the Fed from supervision would deprive it of a "window into the banking system," and thus impair its effectiveness in implementing monetary policy; and the implicit objection that taking the Fed out of supervision would decimate the Reserve Banks and thus undermine an important pillar of the Fed's independence.
- Third, there has never been any appreciable public constituency for such change. The banking industry and other interest groups have learned to live with -- and take advantage of -- the existing system, and they have not been anxious to change things. One does not even hear a clamor from public interest or consumer groups for such change.
- Finally, as illogical as it might be, the present system works pretty well, and enhanced cooperation and coordination in recent years has made it work even better.

While the challenge of addressing the funding problem in the context of regulatory restructuring is a formidable one, there are alternative approaches that should be considered -- measured steps targeted to the problem that would avoid the difficulties presented by more far-reaching proposals to dismantle and reassemble the current supervisory structure.

I have proposed that we replace the system under which the OCC and state supervisors fund themselves through direct assessments, with a system that would draw on the earnings of the insurance fund. Such an approach would have multiple advantages:

- First, it would be supremely logical. After all, protection of the insurance fund is a major purpose of bank supervision. Charging the costs of supervision to the fund would place supervision on a sounder and fairer footing, relieving national banks of the unique and discriminatory burden of directly funding the costs of their own supervision -- and of the grossly unfair burden of subsidizing the cost of supervision of their state bank competitors.
- Second, it would promote the equitable and efficient allocation of the costs and benefits of deposit insurance, and ensure that all supervisors have the resources necessary to provide effective bank supervision, regardless of changes in the economy or the structure of the banking system.
- Finally, it would revitalize the dual banking system by eliminating the distorting effects of a selective subsidy, while retaining the element of charter choice that has long been its hallmark.

Under our proposal, federal and state agencies would jointly formulate an allocation formula initially calibrated to provide the OCC and state agencies with resources equivalent to their current levels. This "baseline" allocation would be adjusted annually under the formula to take account of changes in the composition and condition of each agency's constituent banks, so that allocations from the fund would be automatic and nondiscretionary. The great benefit of this proposal is that it would significantly reduce, if not eliminate, reliance on the federal subsidy to state banks as a major determinant of charter choice. Banks would then make charter decisions based on such considerations as the quality of supervision and the suitability of the charter for their business objectives -- a far healthier environment for the dual banking system than at present. It would provide the basis for restoration of salutary competition among the regulators -- a "competition in excellence," that would restore the focus to the qualitative aspects of charter choice, rather than competition based on subsidized pricing.

There are some who believe that the national charter is so far superior to the state charter that an equitable allocation of the costs of supervision would result in a massive outflow of banks from state systems, and on this ground they oppose our suggested solution. But while I bow to no one in my enthusiasm for the national charter, the state charter has significant attributes of its own. Many states have been very innovative in granting powers to their banks that national banks do not yet have, and many states have adopted "wild card" laws that allow their banks to exercise many powers permissible for national banks. No comparable "reverse wild card" law affords reciprocal benefits for national banks. In the area of interstate branching, state supervisors have been very resourceful in reducing the burdens of duplicative regulation on banks operating in multiple states, and Congress has enacted "equalization" provisions giving state banks with interstate branches many of the benefits that national banks have in that connection.

Whatever one's view might be of the relative merits of the two charters, however, I think it's fair to say that the state charter is not in such a state of decrepitude that it needs almost a billion dollars a year in federal subsidies to shore it up -- particularly subsidies that are delivered not pursuant to congressional mandate, but through the discretionary decisions of those federal regulators who have a self-interest in maintaining these banks as their constituents. If, indeed, an elimination of these subsidies would result in a major outflow of state banks to the national charter, we should all be alarmed, and we should focus on more fundamental concerns about state systems. Similarly, maintenance of a subsidy that is intended to protect the role of the Federal Reserve Banks in supervision diverts attention from what may be more significant structural issues in the Federal Reserve System. If there is reason to have such concerns, we should address them more forthrightly, and we should not obscure them with subsidy practices that have the purpose or effect of maintaining a particular regulatory share of market.

But I do not for a minute think that elimination of the subsidy would cause an exodus of state banks. Supervisory costs are naturally a concern for all banks, but I don't believe that major banking organizations make their charter choice simply on the basis of supervisory fees. I see no reason, to put a somewhat finer point on it, why the Federal Reserve should be concerned that its perfectly legitimate interest in being meaningfully involved with the banking system would be undermined if the discriminatory cost burden now borne by national banks were eliminated.

When we began to talk about the fee disparity issue in public nearly two years ago, it was the target of a fair amount of derision. Predictably, those who derided it most were many of the same people who were benefiting most from the subsidies I've been discussing.

Now I think it's widely acknowledged that we do need to revisit the way we fund bank supervision. But the changes needn't -- and shouldn't -- be radical ones. Ungainly though it is, our system of supervision has been too successful to scuttle. Indeed, our goal should be to strengthen our supervisory system by preserving and enhancing independence.

I believe that the proposal I have sketched today meets that standard. I commend it to your attention -- and look forward to continuing the dialogue well underway with everyone who has a stake in the issue.