

# The Regulation of Depository Institutions: Seismic Change Coming?

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Except for the elimination of the Federal Home Loan Bank Board and Federal Savings and Loan Insurance Corp., and the creation of the Office of Thrift Supervision (OTS) in 1989, the basic structure of the U.S. banking regulatory system, developed through a patchwork of legislation dating back to the Civil War, has remained unchanged since the 1930s. This observation is true despite numerous reorganization proposals from government, academic and business sources through the years including, most recently, one from then President George W. Bush's Department of the Treasury.

Notwithstanding widespread recognition that the existing system has flaws, a comprehensive restructuring plan never saw the light of day for numerous reasons. Those reasons include a sense of "if it ain't broke, don't fix it" and concern that any restructuring effort would be hampered by infighting among regulatory agencies seeking to preserve or increase their roles.

With the existing economic crisis, a significant regulatory restructuring may finally occur, as many have concluded

that the system is broken and no longer works. President Obama has said that updating the financial regulatory system is a top legislative priority. Sen. Christopher Dodd, Chairman of the Senate Banking Committee, and House Financial Services Committee Chairman Barney Frank have indicated an intent to pursue restructuring of financial services regulation and commenced hearings. So it appears that the regulatory system that bankers have become accustomed to, if not entirely satisfied by, is in for a substantial overhaul.

The concept of a "systemic risk regulator" has been widely mentioned. Such a regulator would be responsible for overseeing the soundness of the entire financial system. Presumably such a regulator would have authority across all financial services sectors, including banking, capital markets and insurance. The issue of "too big to fail" is an integral component of systemic risk. A related concept is the designation of an agency that would resolve, outside of bankruptcy, failed systemically important financial companies (SIFCs), similar to the way in which the Federal Deposit Insurance Corp. (FDIC) resolves failed banks and savings associations.

Both the Federal Reserve Board (FRB) and the FDIC have been mentioned as possibilities for a systemic risk role.

Recently the concept of a “systemic risk council,” consisting of multiple regulatory agencies, has been advanced. Such a council would identify and monitor SIFCs.

Then there is the issue of day-to-day regulation of depository institutions. The clamor to modernize the financial services regulatory system has grown, based on concerns as to safety and soundness and global competitiveness of U.S. financial companies. The existing economic turmoil has created an urgency that is likely to trump the typical arguments for the status quo and make irrelevant the regulatory turf battles that have arisen in the past. The current framework of multiple federal regulators with overlapping jurisdiction appears unlikely to survive.

The Senate Banking Committee has held hearings to solicit the views on restructuring of the current depository institution regulators. As may be expected, disparate opinions were presented.

Comptroller of the Currency John Dugan noted that making the FRB the systemic risk regulator made sense given that agency’s current role, but questioned whether that assignment would place too much responsibility in one agency. He argued for preserving the FRB as bank holding company regulator, to facilitate its “window” into banking in view of its monetary policy role, and for retaining a separate prudential bank regulator at the federal level. Comptroller Dugan was opposed to giving the FDIC authority to resolve failed SIFCs, citing its bank-centric mission.

FDIC Chairman Sheila Bair noted the difficulties caused by the FDIC’s having receivership authority only over failed institutions, but not the institutions’ holding companies and affiliates. She also advocated a bank-like resolution process for SIFCs and suggested that forming a new agency to perform that function may not be efficient. Further, she urged Congress to examine the “fundamental question” of whether there should be limits on the size and complexity of SIFCs. In subsequent testimony, Chairman Bair proposed the systemic risk council idea.

FRB Governor Daniel Tarullo stressed the need for a comprehensive supervisory framework, similar to the Bank Holding Company Act, for SIFCs. He also called for a resolution regime outside bankruptcy

for SIFCs, including bank holding companies. He expressed the belief, as FRB Chairman Ben Bernanke has before, that the FRB, as central bank, would need to be involved in identifying and addressing systemic risk, if not itself the systemic risk regulator.

North Carolina Banking Commissioner Joseph Smith, representing the Conference of State Bank Supervisors, argued against consolidating financial regulation at the federal level, suggesting instead a coordinated system of state and federal supervision. Commissioner Smith called for a bifurcated regulatory system whereby systemically important institutions would be more stringently regulated than less complex regional and community banks. He also urged eliminating federal preemption of state consumer protection laws as to federally chartered banks and savings associations.

Then Acting OTS Director Scott Polakoff advocated establishing two federal depository institution regulatory agencies. One would charter and supervise depository institutions that primarily engage in providing products to consumers and communities, and one would charter and regulate institutions that primarily provide services to commercial enterprises. The two agencies would also be the primary federal regulators for state-chartered depository institutions that focus on the business lines within their jurisdictions, and holding companies of their regulated institutions, and would regulate non-depositories that engage in similar activities. He also argued that the mutual form of organization should continue to exist.

Subsequently, before the House Financial Services Committee, Treasury

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Secretary Geithner advocated a systemic risk regulator, without specifying its identity. He also proposed a structure under which the FDIC would be given authority, under certain circumstances, to resolve SIFCs. The Treasury Secretary has not, at this writing, advanced a comprehensive proposal for restructuring day-to-day depository institution regulation.

The restructuring process raises numerous questions for bankers who have been

acclimated to the existing regulatory system:

- Will the FRB's role as regulator of bank holding companies be eliminated in favor of becoming the systemic risk regulator?
- Will depository institutions continue to be regulated by charter or, instead, based on their sizes or lines of businesses?
- Will the roles of the states in banking regulation be materially altered?
- Will the OTS and the Office of the Comptroller of the Currency be consolidated?
- Exactly which federal agency will be

responsible for day-to-day depository institution regulation?

- Will there continue to be multiple federal depository institution charters or will there be a single uniform charter?
- Will the FDIC continue as a regulator, become solely a deposit insurer, or take on a broader role of resolving failed SIFCs in addition to depository institutions?
- Will there be, as some have suggested, a separate regulatory and examination authority for consumer compliance laws?
- Will credit unions continue to be insured and regulated at the federal level by a separate agency, or will they be brought into an overall streamlining effort?
- How will nondepository lenders be regulated?
- Will legislators be sensitive to the unique concerns of mutual organizations?

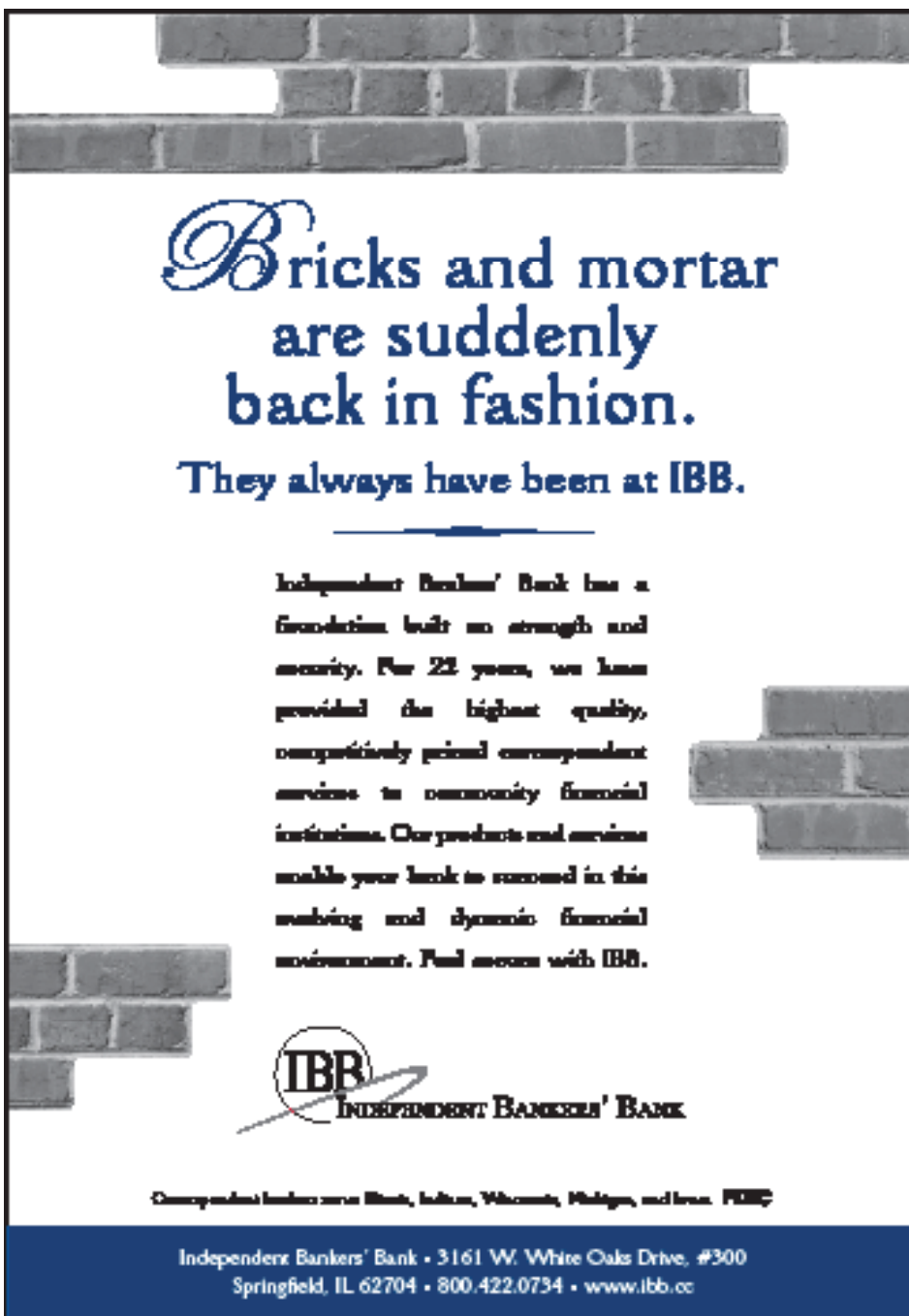
Indeed, those issues relate only to the topic of depository institution regulation without even considering changes that may occur in the regulation of other financial services, such as investment banking, capital and commodities markets and insurance.

Depository institutions of all types, sizes and characteristics have reason to be attentive to ongoing legislative developments concerning financial services regulatory restructuring. Today's bankers have never experienced changes in regulatory structure such as those that are likely to arise from this process. ♦

## Indiana Banks Lauded in *NY Times*

The *New York Times* published an article on May 12 touting the good news that the Indiana banking community is strong, sound and secure. The article, titled "We're Dull, Small Banks Say, but Have Profits," further distinguishes between the prudent business practices of Indiana banks and the "risk-addicted style" of coastal megabanks.

Reporter David Segal from the *New York Times* visited the IBA Mega Conference in April. To view the complete article online, go to the newspaper's website at [www.nytimes.com](http://www.nytimes.com), and enter "have profits" in the search box. ♦



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