Challenges to the Dual Banking System: The Funding of Bank Supervision

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This article examines the funding of bank supervision in the context of the dual banking system. Since 1863, commercial banks in the United States have been able to choose to organize as national banks with a charter issued by the Office of the Comptroller of the Currency (OCC) or as state banks with a charter issued by a state government. The choice of charter determines which agency will supervise the bank: the primary supervisor of nationally chartered banks is the OCC, whereas state-chartered banks are supervised jointly by their state chartering authority and either the Federal Deposit Insurance Corporation (FDIC) or the Federal Reserve System (Federal Reserve).[1] In their supervisory capacity, the FDIC and the Federal Reserve generally alternate examinations with the states.

The choice of charter also determines a bank's powers, capital requirements, and lending limits. Over time, however, the powers of state-chartered and national banks have generally converged, and the other differences between a state bank charter and a national bank charter have diminished as well. Two of the differences that remain are the lower supervisory costs enjoyed by state banks and the preemption of certain state laws enjoyed by national banks. The interplay between these two differences is the subject of this article. Specifically, we examine how suggestions for altering the way banks pay for supervision may have (unintended) consequences for the dual banking system.

For banks of comparable asset size, operating with a national charter generally entails a greater supervisory cost than operating with a state charter. National banks pay a supervisory assessment to the OCC for their supervision. Although state-chartered banks pay an assessment for supervision to their chartering state, they are not charged for supervision by either the FDIC or the Federal Reserve. A substantial portion of the cost of supervising state-chartered banks is thus borne by the FDIC and the Federal Reserve. The FDIC derives its funding from the deposit insurance funds, and the Federal Reserve is funded through

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[1] In addition, the Federal Reserve supervises the holding companies of commercial banks, and the FDIC has backup supervisory authority over all insured depository institutions.

the interest earned on the Treasury securities that it purchases with the reserves commercial banks are required to deposit with it. By contrast, the OCC relies almost entirely on supervisory assessments for its funding.

The current funding system is a matter of concern because—with fewer characteristics distinguishing the national bank charter from a state bank charter—chartering authorities increasingly compete for member banks on the basis of supervisory costs and the ways in which those costs can be contained. Furthermore, two recent trends in the banking industry have been fueling the cost competition: increased consolidation and increased complexity. Consolidation has greatly reduced the number of banks, thereby reducing the funding available to the supervisory agencies, while the increased complexity of a small number of very large banking organizations has put burdens on examination staffs that may not be covered by assessments. Together, these three factors—the importance of cost in the decision about which charter to choose, the smaller number of banks, and the special burdens of examining large, complex organizations—have put regulators under financial pressures that may ultimately undermine the effectiveness of prudential supervision. Cost competition between chartering authorities could affect the ability to supervise insured institutions adequately and effectively and may ultimately affect the viability of the dual banking system.

The concern about the long-term viability of the dual banking system derives from changes to the balance between banking powers and the costs of supervision. If the balance should too strongly favor one charter over the other, one of the charters might effectively disappear. Such a disappearance has already been prefigured by events in the thrift industry.

The next section contains a brief history of the dual banking system and charter choice, explaining why the cost of supervision has become so important. Then we examine the mechanisms currently in place for funding bank supervision, and discuss the two structural changes in the banking industry that have fueled the regulatory competition. Next we draw on the experiences of the thrift industry to examine how changes in the balance between powers and the cost of supervision can influence the choice of charter type. Alternative means for funding bank supervision, and a concluding section, complete the article.

A Brief History of the Dual Banking System and Charter Choice

Aside from the short-lived exceptions of the First Bank of the United States and the Second Bank of the United States, bank chartering was solely a function of the states until 1863. Only in that year, with the passage of the National Currency Act, was a federal role in the banking system permanently established. The intent of the legislation was to assert federal control over the monetary system by creating a uniform national currency and a system of nationally chartered banks through which the federal government could conduct its business.[2] To charter and supervise the national banks, the act created the Office of the Comptroller of the Currency (OCC). The act was refined in 1864 with passage of the National Bank Act.

Once the OCC was created, anyone who was interested in establishing a commercial bank could choose either a federal or a state charter. The decision to choose one or the other was relatively clear-cut: the charter type dictated the laws under which the bank would operate and the agency that would act as the bank's supervisor. National banks were regulated under a system of federal laws that set their capital, lending limits, and powers. Similarly, state-chartered banks operated under state laws.

[2] The new currency–U.S. bank notes, which had to be backed by Treasury securities–would trade at par in all U.S. markets. The new currency thus created demand for U.S. Treasuries and helped to fund the Civil War. At the time, it was widely believed that a system of national banks based on a national currency would supplant the system of state-chartered banks. Indeed, many state-chartered banks converted to a national charter after Congress placed a tax on their circulating notes in 1865. However, innovation on the part of state banks–the development of demand deposits to replace bank notes–halted their demise. See Hammond (1957), 718–34.

When the Federal Reserve Act was passed in 1913, national banks were compelled to become members of the Federal Reserve System; by contrast, state-chartered banks could choose whether to join. Becoming a member bank, however, meant becoming subject to both state and federal supervision. Accordingly, relatively few state banks chose to join. The two systems remained largely separate until passage of the Banking Act of 1933, which created the Federal Deposit Insurance Corporation. Under the act national banks were required to obtain deposit insurance; state banks could also obtain deposit insurance, and those that did became subject to regulation by the FDIC.[3] The vast majority of banks obtained federal deposit insurance; thus, although banks continued to have their choice of charter, neither of the charters would relieve a bank of federal oversight.

As noted above, over the years, the distinctions between the two systems greatly diminished. During the 1980s, differences in reserve requirements, lending limits, and capital requirements disappeared or narrowed. In 1980, the Depository Institutions Deregulation and Monetary Control Act gave the benefits of Federal Reserve membership to all commercial banks and made all subject to the Federal Reserve's reserve requirements. In 1982, the Garn–St Germain Act raised national bank lending limits, allowing these banks to compete better with state-chartered banks. Differences continued to erode in the remaining years of the decade, as federal supervisors instituted uniform capital requirements for banks.

As these differences in their charters were diminishing, both the states and the OCC attempted to find new ways to enhance the attractiveness of their respective charters. The states have often permitted their banks to introduce new ideas and innovations, with the result these institutions have been able to experiment with relative ease. Many of the ideas thus introduced have been subsequently adopted by national banks. In the early years of the dual banking system, for example, state banks developed checkable deposits as an alternative to bank notes. Starting in the late 1970s, a spate of innovations took root in state-chartered banks: interest-bearing checking accounts, adjustable-rate mortgages, home equity loans, and automatic teller machines were introduced by state-chartered banks. During the 1980s the states took the lead in deregulating the activities of the banking industry. Many states permitted banks to engage in direct equity investment, securities underwriting and brokerage, real estate development, and insurance underwriting and agency.[4] Further, interstate banking began with the development of regional compacts at the state level.[5] At the federal level, the OCC expanded the powers in which national banks could engage that were considered "incidental to banking." As a result, national banks expanded their insurance, securities and mutual fund activities.

Then in 1991, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) limited the investments and other activities of state banks to those permissible for national banks and the differences between the two bank charters again narrowed.[6] In response, most states enacted wild-card statutes that allowed their banks to engage in all activities permitted national banks.[7]

[3] While most states subsequently required their banks to become federally insured, some states continued to charter banks without this requirement. Banks without federal deposit insurance continued to be supervised exclusively at the state level. After the savings and loan crises in Maryland and Ohio in the mid-1980s, when state-sponsored deposit insurance systems collapsed, federal deposit insurance became a requirement for all state-chartered banks.

[4] For a comparison of state banking powers beyond those considered traditional, see Saulsbury (1987).

[5] Beginning in the late 1970s and early 1980s, the states began permitting bank holding companies to own banks in two or more states. State laws governing multistate bank holding companies varied: some states acted individually, others required reciprocity with another state, and still others participated in reciprocal agreements or compacts that limited permissible out-of-state entrants to those from neighboring states. In 1994, Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act, which removed most of the remaining state barriers to bank holding company expansion and authorized interstate branching. See Holland et al. (1996).

[6] As amended by FDICIA, Section 24 of the Federal Deposit Insurance Act (12 U.S.C. 1831a) makes it unlawful, subject to certain exceptions, for an insured state bank to engage directly or indirectly through a subsidiary as principal in any activity not permissible for a national bank unless the FDIC determines that the activity will not pose a significant risk to the funds and the bank is in compliance with applicable capital standards. For example, the FDIC has approved the establishment of limited-liability bank subsidiaries to engage in real estate or insurance activities.

[7] For a discussion of the legislative and regulatory changes affecting banks during the 1980s and early 1990s, see FDIC (1997), 88–135.

Most recently, competition between the two charters for member institutions has led the OCC to assert its authority to preempt certain state laws that obstruct, limit, or condition the powers and activities of national banks. As a result, national banks have opportunities to engage in certain activities or business practices not allowable to state banks.[8] The OCC is using this authority to ensure that national banks operating on an interstate basis are able to do so under one set of laws and regulations—those of the home state. In this regard, for banks operating on an interstate basis, the national bank charter offers an advantage since states do not have comparable preemption authority. (In theory, however, nothing prevents two or more states from harmonizing their banking regulations and laws so that state banks operating throughout these states would face only one set of rules.) Thus, the OCC's preemption regulations reinforce the distinction between the national and state-bank charters that characterizes the dual banking system.

Funding Bank Supervision

The gradual lessening of the differences between the two charters has brought the disparities in the fees banks pay for supervision into the spotlight as bank regulators have come under increased fiscal pressure to fund their operations and remain attractive choices. How bank supervision is ultimately funded will have implications for the viability of the dual banking system. It has always been the case that most state bank regulators and the OCC are funded primarily by the institutions they supervise,[9] but it used to be that differences in the fees paid by banks for regulatory supervision were secondary to the attributes of their charters. Now, however, the growing similarity of attributes has made the cost of supervision more important in the regulatory competition between states and the OCC to attract and retain member institutions. This competition has tempered regulators' willingness to increase assessments and has left them searching for alternative sources of funding that will not induce banks to switch charters. The question for state bank regulators and the OCC, then, is how to fund their operations while remaining attractive charter choices in an era of fewer but larger banks. Here we summarize the funding mechanisms currently in place, and in a later section we discuss alternative means for funding bank supervision.

The OCC's Funding Mechanism

In the mid-1990s, after charter changes by a number of national banks,[10] the OCC began a concerted effort to reduce the cost of supervision, especially for the largest banks. The agency instituted a series of reductions in assessment fees and suspended an adjustment in its assessment schedule for inflation.[11] When the inflation adjustment was reinstated in 2001, it was applied only to the first $20 billion of a bank's assets. In 2002, the OCC revised its general assessment schedule and set a minimum assessment for the smallest banks. These changes reduced the cost of supervision for many larger banks, while increasing the cost for smaller banks—thus, making the assessment schedule even more regressive than previously. For example, national banks with assets of $2 million or less faced an assessment increase of at least 64 percent, while larger banks experienced smaller percentage increases or actual reductions in assessments.

[8] On January 7, 2004, the OCC issued two final regulations to clarify aspects of the national bank charter. The purpose cited was to enhance the ability of national banks to plan their activities with predictability and operate efficiently in today's financial marketplace. The regulations address federal preemption of state law and the exclusive right of the OCC to supervise national banks. The first regulation concerns preemption, or the extent to which the federally granted powers of national banks are exempt from state laws. State laws that concern aspects of lending and deposit taking, including laws affecting licensing, terms of credit, permissible rates of interest, disclosure, abandoned and dormant accounts, checking accounts, and funds availability, are preempted under the regulation. The regulation also identifies types of state laws from which national banks are not exempt. A second regulation concerns the exclusive powers of the OCC under the National Bank Act to supervise the banking activities of national banks. It clarifies that state officials do not have any authority to examine or regulate national banks except when another federal law has authorized them to do so. See OCC (2004b, 2004c).

[9] Although the OCC is a bureau of the U.S. Treasury Department, it does not receive any appropriated funds from Congress.

[10] For example, in 1994, 28 national banks chose to convert to a state bank charter; another 15 did so in 1995. See Whalen (2002).

[11] The OCC's assessment regulation (12 C.F.R., Part 8) authorizes rate adjustments up to the amount of the increase in the Gross Domestic Product Implicit Price Deflator for the 12 months ending in June.

The OCC charges national banks a semiannual fee on the basis of asset size, with some variation for other factors (see below). The semiannual fee is determined by the OCC's general assessment schedule. As table 1 and figure 1 show, the marginal or effective assessment rate declines as the asset size of the bank increases.

The marginal rates of the general assessment schedule are indexed for recent inflation, and a surcharge—designed to be revenue neutral—is placed on banks that require increased supervisory resources, ensuring that well-managed banks do not subsidize the higher costs of supervising less-healthy institutions. The surcharge applies to national banks and federal branches and agencies of foreign banks that are rated 3, 4, or 5 under either the CAMELS or the ROCA rating system.[12] For banking organizations with multiple national bank charters, the assessments charged to their non-lead national banks are reduced.[13] In 2004, these general assessments provided approximately 99 percent of the agency's funding.[14] The remaining 1 percent was provided by interest earned on the agency's investments and by licensing and other fees. As indicated in note 9, the OCC does not receive any appropriated funds from Congress.

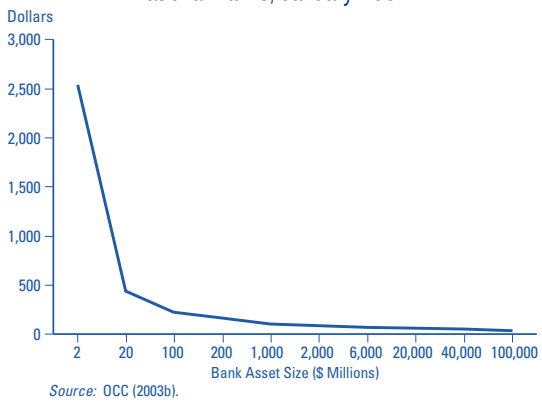
[12] As part of the examination process, the supervisory agencies assign a confidential rating, called a CAMELS (Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to market risk) rating, to each depository institution they regulate. The rating ranges from 1 to 5, with 1 being the best rating and 5 the worst. ROCA (Risk management, Operational controls, Compliance, and Asset quality) ratings are assigned to the U.S. branches, agencies, and commercial lending companies of foreign banking organizations and also range from 1 to 5. See Board et al. (2005).

[13] Non-lead banks receive a 12 percent reduction in fees in the OCC's assessment schedule. See OCC (2003b).

[14] See OCC (2004a), 7.

Figure 1

Assessment Paid per $1 Million in Assets
National Banks, January 2004



Source: OCC (2003b).
Note: These rates apply to lead national banks that are CAMELS/ROCA-rated 1 or 2 (see footnote 12).

Table 1

OCC General Assessment Fee Schedule
January 2004

If total reported assets are		The semiannual assessment is		
Over ($ million)	But not over ($ million)	This amount ($)	Plus	Of excess over ($ million)
0	2	5,075	.000000000	0
2	20	5,075	.000210603	2
20	100	8,866	.000168481	20
100	200	22,344	.000109512	100
200	1,000	33,295	.000092663	200
1,000	2,000	107,425	.000075816	1,000
2,000	6,000	183,241	.000067393	2,000
6,000	20,000	452,813	.000057343	6,000
20,000	40,000	1,255,615	.000050403	20,000
40,000		2,263,675	.000033005	40,000

Source: OCC (2003b).
Note: These rates apply to lead national banks that are CAMELS/ROCA-rated 1 or 2 (see footnote 12).

The States' Funding Mechanisms

The assessment structures used by the states to fund bank supervision vary considerably, although some features are common to most of them. Most states charge assessments against some measure of bank assets, and in many the assessment schedule is regressive, using a declining marginal rate. (See the appendix for several representative examples of state assessment schedules.) More than half of all states also impose an additional hourly examination fee. Only a few states link their assessments to bank risk—for example, by factoring CAMELS ratings into the assessment schedule.[15]

To illustrate the differences in the supervisory assessment fees charged by the OCC and the states, we calculated approximate supervisory assessments for two hypothetical banks, one with $700 million in assets and one with $3.5 billion. We used assessment schedules for the OCC and four states—Arizona, Massachusetts, North Carolina, and South Dakota—whose assessment structures are representative of the different types of assessment schedules used by the states. Like the OCC, Arizona and North Carolina use a regressive assessment schedule and charge assessments against total bank assets; however, neither makes any adjustment based on bank risk. Arizona's assessment schedule makes finer gradations at lower levels of asset size than does North Carolina's schedule. Massachusetts uses a risk-based assessment schedule in which assessments are based on asset size and CAMELS rating. Banks are grouped as CAMELS 1 and 2, CAMELS 3, and CAMELS 4 and 5. Within each CAMELS group there is a regressive assessment schedule so that banks are charged an assessment based on total bank assets. South Dakota charges a flat-rate assessment against total bank assets.

The results are shown in table 2. As expected, the assessments for supervision paid by state-chartered banks are significantly less than those paid by comparably sized OCC-supervised banks. As noted above, a likely cause of this disparity is that the states share their supervisory responsibilities with federal regulatory agencies (that is, with the FDIC and the Federal Reserve) that do not charge for their supervisory examinations of state-chartered banks.

[15] Among the states that rely primarily on hourly examination fees to cover their costs are Delaware and Hawaii. States relying on a flat-rate assessment include Maine, Nebraska, and South Dakota. Those using a risk-based assessment scheme include Iowa, Massachusetts, and Michigan. Those assessing on the basis of their expected costs include Colorado, Louisiana, and Minnesota. One state, Tennessee, explicitly limits its assessments to no more than the amount charged by the OCC for a comparable national bank. For a listing of assessment schedules and fees by state, see CSBS (2002), 45–63.

Table 2

Comparison of Annual Supervisory Assessment Fees
OCC and Selected States, 2002

	$700 million bank		$3.5 billion bank			
	Assessment	Effective Asssessment per Thousand $	Assessment	Effective Assessment per Thousand $	Difference in Assessments (percent)	Incidence of Assessment Schedule
Arizona	$ 54,000	$.077	$205,000	$.058	+279%	Regressive
Massachusetts	52,000	.074	227,000	.064	+336	Regressive
North Carolina	62,500	.089	177,500	.051	+184	Regressive
South Dakota	35,000	.050	175,000	.050	+400	Flat
OCC	159,000	.227	569,000	.163	+257	Regressive

Source: CSBS (2002) and OCC (2002).

Note: The calculation of assessments for state-chartered banks is based on rate schedules provided by the states to CSBS. Where applicable, the assessment is calculated for a CAMELS 1- or 2-rated bank.

The Effect on Regulatory Competition of Changes in the Banking Industry

Cost competition between state regulators and the OCC, and among state regulators themselves, has been fueled by two important structural changes that have occurred in the banking industry over the past two decades. The number of bank charters has declined, largely because of increased bank merger and consolidation activity, and the size and complexity of banking organizations has increased.

The first change—a decline in the number of charters—means that the OCC and state regulators are competing for a declining member base. As we have seen, the cost of supervision remains one of the few distinguishing features of charter type. In ways that we explain below, the declining member base puts an additional constraint on the regulators' ability to raise assessment rates, even in the face of rising costs to themselves.

The second important structural change of the past two decades—the increasing complexity of institutions—also complicates the funding issue, for it may impose added supervisory costs that are not reflected in the current assessment schedules. As explained in the previous section, the OCC and most states currently charge examination fees on the basis of an institution's assets, but for a growing number of institutions, that assessment base does not reflect the operations of the bank.

The Net Decline in the Number of Bank Charters

The net decline in the number of banking charters since 1984 has resulted from two main factors. One is the lifting of legal restrictions on the geographic expansion of banking organizations—a lifting that provided incentive and opportunity for increased mergers and consolidation in the banking industry—and the other is the wave of bank failures that occurred during the banking crisis of the late 1980s and early 1990s.[16]

Until the early 1980s, banking was largely a local business, reflecting the limits placed by the states on intra- and interstate branching. At year-end 1977, 20 states allowed statewide branching, and the remaining 30 states placed limits on intrastate branching.[17] However, as the benefits of geographic diversification became better understood, many states began to lift the legal constraints on branching. By mid-1986, 26 states allowed statewide branch banking, while only 9 restricted banks to a unit banking business. By 2002, only 4 states placed any limits on branching.[18] Interstate banking, which was just beginning in the early 1980s, generally required separately capitalized banks to be established within a holding company structure. Interstate branching was virtually nonexistent.[19]

The passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 imposed a consistent set of standards for interstate banking and branching on a nationwide basis.[20] With the widespread lifting of the legal constraints on geographic expansion that followed, bank holding companies began to consolidate their operations into fewer banks. Bank acquisition activity also accelerated.

Bank failures took a toll on the banking industry as well, reaching a peak that had not been seen since the Great Depression: from 1984 through 1993, 1,380 banks failed.[21] Mergers and acquisitions, however, remained the single largest contributor to the net decline in banking charters. Overall, the number of banks declined dramatically from 1984 through 2004, falling from 14,482 to 7,630. At the same time, the average asset size of banks increased. (See table 3.)

[16] See FDIC (1997).

[17] Twelve of the 30 states permitted only unit banking, and the other 18 permitted only limited intrastate branching. See CSBS (1977), 95.

[18] See CSBS (2002), 154. The four states were Iowa, Minnesota, Nebraska, and New York.

[19] By the early 1980s, 35 states had enacted legislation providing for regional or national full-service interstate banking. Most regional laws were reciprocal, restricting the right of entry to banking organizations from specified states. See Saulsbury (1986), 1–17.

[20] The act authorized interstate banking and branching for U.S. and foreign banks to be effective by 1997. See FDIC (1997), 126.

[21] See FDIC (2002a), 111.

The rise in interstate banking, in particular, fueled competition both among state regulators and between state regulators and the OCC. Mergers of banks with different state charters caused the amount of bank assets supervised by some state regulators to decline, and the amount supervised by other state regulators to increase commensurately.[22] Similarly, mergers between state-chartered and national banks caused assessment revenues and supervisory burden to shift between state regulators and the OCC. While the number of banks was thus declining, the average asset size of the banks was increasing. Because of the regressive nature of most assessment schedules, this resulted in a decline of assessment revenues per dollar of assets supervised. For bank holding companies, this provided an incentive to merge their disparate banking charters. For supervisors, mergers have proved more problematic. In general, the regressive nature of most assessment schedules suggests that regulators enjoy economies of scale in supervision. However, given the increased complexity of many large banks (discussed below), the existence of such economies is questionable.[23]

A hypothetical example (taken from table 2) further highlights the effects of consolidation and merger activity on the regulatory agencies. All else equal (that is, holding constant the assessment schedules shown in table 2), changes in the structure of the industry over time have reduced the funding available to the supervisory agencies. Consider a bank holding company with five national banks, each with an average asset size of $700 million. The lead bank would pay an annual assessment to the OCC of $159,000, and each of the remaining banks would be assessed $139,920.[24] The total for the five banks would be $718,680. But if these banks were to merge into one national bank with $3.5 billion in assets, the assessment owed the OCC would decline to $569,000—a saving to the bank of $149,680 in assessment fees for 2002. Similar results can be derived for each of the states in the table except South Dakota, which has a flat-rate assessment schedule.

The Growth of Complex Banks

During the 1990s, we have seen the emergence of what are termed large, complex banking organizations (LCBOs) and the growth of megabanks

[22] When banks merge, management must choose which bank charter to retain. That decision will determine the combined bank's primary regulator.
[23] The nature and amount of such scale economies in bank examination are beyond the scope of this article to investigate.
[24] This calculation reflects the 12 percent reduction in fees that non-lead banks receive. See OCC (2003b).

Table 3

Number and Average Assets of Commercial Banks
by Charter, 1984–2004

	1984	1989	1994	1999	2004	Change 1984–2004	Percent change 1984–2004
Number of Banks							
National Charter	4,902	4,175	3,076	2,365	1,906	(2,996)	(61)%
State Charter	9,580	8,534	7,376	6,215	5,724	(3,856)	(40)
Total	14,482	12,709	10,452	8,580	7,630	(6,852)	(47)
Average Asset Size ($Millions)							
National Charter	$305.6	$ 473.8	$ 733.9	$1,383.2	$2,938.9	$2,633.3	862%
State Charter	105.5	154.8	237.9	396.4	491.2	385.7	366
All Banks	173.2	259.6	383.9	668.4	1,102.6	929.4	537

Source: FDIC Call Reports and FDIC (2002a). Figures not adjusted for inflation.

owned by these organizations.[25] In 1992, 90 banks controlled one-half of industry assets; by the end of the decade, the number of banks that controlled one-half of industry assets had shrunk to 26, and at year-end 2004 to 13.[26] These large banks engage in substantial off-balance-sheet activities and hold substantial off-balance-sheet assets. As a result, existing assessment schedules based solely on asset size have become less-accurate gauges of the amount of supervisory resources needed to examine and monitor them effectively.

Because of their size, geographic span, business mix (including nontraditional activities), and ability to rapidly change their risk profile, megabanks require substantial supervisory oversight and therefore impose extensive new demands on bank regulators' resources. In response, supervisors have created a continuous-time approach to LCBO supervision with dedicated on-site examiners—an approach that is substantially more resource-intensive than the traditional discrete approach of annual examinations used for most banks.

For example, the OCC—through its dedicated examiner program—assigns a full-time team of examiners to each of the largest national banks (at year-end 2004, the 25 largest). In size, these teams of examiners range from just a few to 50, depending on the bank's asset size and complexity. The teams are supplemented with specialists—such as derivatives experts and economists—who assist in targeted examinations of these institutions.[27]

Like the trend toward greater consolidation of the industry, the trend toward greater complexity leads us to question the adequacy of the funding mechanism for bank supervision. The need for additional resources to supervise increasingly large and complex institutions, combined with the regulators' limited ability to raise assessment rates given their concerns with cost competition, creates a potentially unstable environment for banking supervision. If regulatory competition on the basis of cost should yield insufficient funding, the quality of the examination process might suffer. To ensure the adequacy of the supervisory process, the potential for a funding problem must be addressed. In addressing this issue, however, the possibility for other unintended consequences must not be overlooked. In particular, solutions to the funding problem could bring into question the long-term survivability of the dual banking system. In the next section we look at a lesson from the thrift industry to illustrate this problem.

Funding Supervision: Lessons from the Thrift Industry

The history of the thrift industry shows how the choice of charter type can be influenced by changes in the tradeoff between the powers conferred by particular charters and the cost of bank supervision, and what that implies for the viability of the dual banking system. Like the commercial banking industry, the thrift industry also operates under a dual chartering system. States offer a savings and loan association (S&L) charter; some states also offer a savings bank charter. At the federal level, the Office of Thrift Supervision (OTS) offers both a federal S&L charter and

[25] LCBOs are domestic and foreign banking organizations with particularly complex operations, dynamic risk profiles and a large volume of assets. They typically have significant on- and off-balance-sheet risk exposures, offer a broad range of products and services at the domestic and international levels, are subject to multiple supervisors in the United States and abroad, and participate extensively in large-value payment and settlement systems. See Board (1999). The lead banks within such organizations form a class of banks termed megabanks. Like their holding companies, they are complex institutions with a large volume of assets–typically $100 billion or more. See, for example, Jones and Nguyen (2005).

[26] The 13 banks that held one-half of banking industry assets as of December 2004 (according to the FDIC Call Reports) were JPMorgan Chase Bank, NA; Bank of America, NA; Citibank, NA; Wachovia Bank, NA; Wells Fargo Bank, NA; Fleet National Bank; U.S. Bank, NA; HSBC USA, NA; SunTrust Bank; The Bank of New York; State Street Bank and Trust Company; Chase Manhattan Bank USA, NA; and Keybank, NA. Of these, only three were state-chartered.

[27] After JPMorgan Chase converted from a state charter (New York) to a national charter (in November 2004), the OCC indicated it would increase its supervisory staff. The OCC is also emphasizing "horizontal" examinations, which use specialists to focus supervisory attention on specific business lines. See *American Banker* (2005).

a federal savings bank (FSB) charter.[28] All state-chartered thrifts are regulated and supervised by their state chartering authority and also by a federal agency—the OTS in the case of state-chartered S&Ls, and the FDIC in the case of state-chartered savings banks.[29]

The Thrift Industry to 1989

Before the 1980s, S&Ls and savings banks operated under limited powers, largely because they served particular functions: facilitating home ownership and promoting savings, respectively.[30] In 1979, changes in monetary policy resulted in steep increases in interest rates, which in turn caused many S&Ls to face insolvency. The books of a typical S&L reflected a maturity mismatch—long-term assets (fixed-rate mortgage loans) funded by short-term liabilities (time and savings deposits). When interest rates spiked, these institutions faced the prospect of disintermediation: depositors moving their short-term savings deposits out of S&Ls and into higher-earning assets. In response, many S&Ls raised the rates on their short-term deposits above the rates they received on their long-term liabilities. The resultant drain on their capital, coupled with rising defaults on their loans, caused some institutions to become insolvent.

In 1980 and again in 1982, Congress enacted legislation intended to resolve the unfolding S&L crisis, turning its attention to interest-rate deregulation and other regulatory changes designed to aid the suffering industry.[31] For federally chartered thrifts, the requirements for net worth were lowered, ownership restrictions were liberalized, and powers were expanded. The Federal Home Loan Bank Board (FHLBB) subsequently extended many of these relaxed requirements to state-chartered S&Ls by regulatory action.[32] Congress also raised the coverage limit for federal deposit insurance from $40,000 to $100,000 per depositor per institution, and lifted interest-rate ceilings. In turn, many states passed legislation that provided similar deregulation for their thrifts.[33]

Despite efforts to contain the thrift crisis throughout the 1980s, the failure rate for S&Ls reached unprecedented levels. Between 1984 and 1990, 721 S&Ls failed—about one-fifth of the industry. At the end of the decade, with passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Congress and the administration finally found a resolution to the crisis. FIRREA authorized the use of taxpayer funds to resolve failed thrift institutions, and it significantly restructured the regulation of thrifts.[34] Federal regulation and supervision of all S&Ls (both state- and federally chartered) and of federally chartered savings banks were removed from the FHLBS and placed under the newly created OTS.[35] Federal regulation and supervision of state-chartered savings banks remained with the FDIC.

[28] Originally S&Ls were chartered to facilitate the home ownership of members by pooling members' savings and providing housing loans. Savings banks, by contrast, were founded to promote the savings of their members; the institutions' assets were restricted to high-quality bonds and, later, to blue-chip stocks, mortgages, and other collateralized lending. Over time, distinctions between S&Ls and savings banks largely disappeared. Additionally, an institution's name may no longer be indicative of its charter type.

[29] Before 1990, federal savings institutions were regulated and supervised by the Federal Home Loan Bank System (FHLBS), which was comprised of 12 regional Federal Home Loan Banks and the Federal Home Loan Bank Board (FHLBB). The FHLBS was created by the Federal Home Loan Act of 1932 to be a source of liquidity and low-cost financing for S&Ls. In 1933, the Home Owners' Loan Act empowered the FHLBS to charter and to regulate federal S&Ls. Savings banks, by contrast, were solely chartered by the states until 1978, when the Financial Institutions Regulatory and Interest Rate Control Act authorized the FHLBS to offer a federal savings bank charter. In 1989, the Financial Institutions Reform, Recovery, and Enforcement Act abolished the FHLBB and transferred the chartering and regulation of the thrift industry from the FHLBS to the OTS. Additionally, the act abolished the thrift insurer, the Federal Savings and Loan Insurance Corporation, and gave the FDIC permanent authority to operate and manage the newly formed Savings Association Insurance Fund. Although the FHLBB was abolished, the Federal Home Loan Banks remained–their duties directed to providing funding (termed advances) to the thrift industry.

[30] For example, thrifts were prohibited from offering demand deposits or making commercial loans–the domain of the commercial banking industry.

[31] These pieces of legislation were respectively, the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn–St Germain Act of 1982.

[32] See FHLBB (1983), 13, and Kane (1989), 38–47.

[33] FDIC (1997), 176. More generally, see FDIC (1997), 167–88 (chap. 4, "The Savings and Loan Crisis and Its Relationship to Banking").

[34] For a discussion of FIRREA and the resolution of the S&L crisis, see ibid., 100–110 and 186–88.

[35] Ibid., 170–72.

FIRREA also imposed standards on thrifts that were at least as stringent as those for national banks. Such standards covered capital requirements, limits on loans to one borrower, and transactions with affiliates. Moreover, FIRREA placed limits on the activities of state-chartered thrifts, with the result that differences in the powers of state- and federally chartered thrift institutions largely disappeared.

The Demise of the State-Chartered S&L

FIRREA's replacement of the FHLBS with the OTS as the regulator of state-chartered S&Ls at the federal level and the restrictions placed on those institutions' powers were especially important in terms of the subject of this article. Like the OCC—but unlike the FHLBS—the OTS does not have an internally generated source of funding for its supervisory activities.[36] The OTS funds itself by charging the institutions it supervises for their examinations.[37] As a result, since 1990 state-chartered S&Ls have faced a double supervisory assessment: they have been assessed both by their state chartering authority and, at the federal level, by the OTS. In contrast, a second set of thrifts—state-chartered savings banks (regulated by the FDIC at the federal level)—continue to pay supervisory assessments only to their state chartering authority. (As noted above, the FDIC does not charge for supervisory exams.) And a third set of thrifts—federally chartered thrifts (both S&Ls and FSBs)—are assessed only by the OTS.

Figure 2 demonstrates that between 1984 and 2004, the number of state-chartered savings institutions declined relative to the number of federally chartered institutions. In 1984, the industry was almost evenly split between the two chartering authorities, but by 2004, only 42 percent of the industry was state chartered. Further, the percentage of all savings institutions whose regulator at the federal level was the OTS or its predecessor (the FHLBS) also declined significantly—dropping from 92 percent in 1984 to 66 percent in 2004.

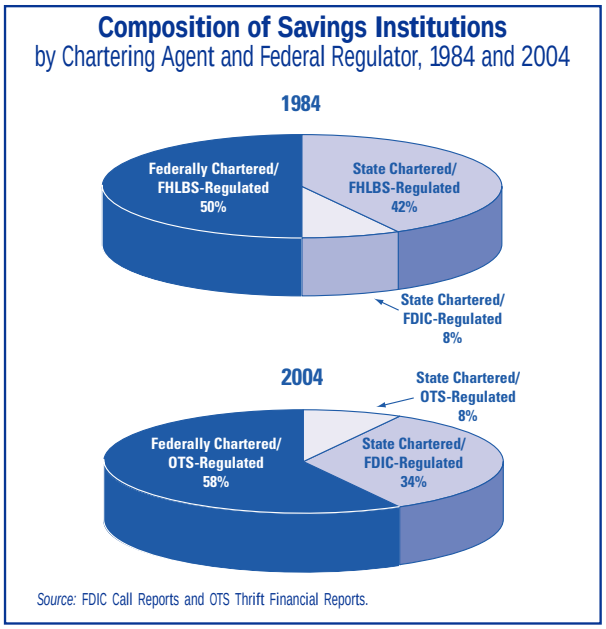
The trends in the composition of the savings industry are further depicted in figures 3 and 4. Figure 3 illustrates trends in charter type and federal regulator for all savings institutions for selected years from 1984 and 2004, and figure 4 depicts trends in the federal regulation specifically of state-chartered savings institutions.[38]

[36] Because the FHLBS had an internal source of funding (the Federal Savings and Loan Share Insurance Fund), it did not impose supervisory fees on either federally or state-chartered thrifts.

[37] The OTS, like the OCC, bases its fees on an institution's asset size, and uses a regressive assessment schedule. Until January 1999, the OTS general assessment schedule based assessments on consolidated total assets. The assessments for troubled institutions were determined by a separate "premium" schedule. Both schedules were regressive: as asset size grew, the marginal assessment rate declined. In January 1999, the assessment system was revised and assessments were based on three components: asset size, condition, and complexity. Two schedules implemented the size component–a general schedule for all thrifts, and an alternative schedule for qualifying small savings associations. The condition component replaced the premium schedule; and the complexity component set rates for three types of activities–trust assets, loans serviced for others, and assets covered in full or in part by recourse obligations or direct credit substitutes. Rates were adjusted periodically for inflation, and other revisions were introduced. Effective July 2004, the OTS implemented a new assessment regulation that revised how thrift organizations are assessed for their supervision. Examination fees for savings and loan holding companies were replaced with a semiannual assessment schedule, and the alternative schedule for small savings institutions was eliminated. The stated goal was to better align OTS fees with the costs of supervision. See OTS (1990, 1998, and 2004).

[38] In the following discussion and in the notation to figures 3, 4 and 6, we use "OTS-regulated" as a proxy for federal regulation that was conducted by the FHLBS for the years before 1990 and has been conducted by the OTS starting in1990.

Figure 2



The shift in the composition of federally regulated state-chartered institutions is most noticeable between 1989 and 1994—the period since the inception of the OTS. During this period, the number of state-chartered/OTS-regulated S&Ls declined by approximately two-thirds, whereas the number of federally chartered/OTS-regulated savings institutions declined by only one quarter. At the same time, the number of state-chartered/FDIC-regulated savings banks grew by almost 30 percent. Since 1994, the number of state-chartered/OTS-regulated S&Ls has declined at almost double the rate of federally chartered/OTS-regulated savings institutions. In fact, state-chartered/OTS-regulated S&Ls have almost disappeared. At year-end 2004, only 104 such institutions remained—a decrease of 93 percent since 1984.

Figure 4, focusing on the trends for state-chartered savings institutions alone, juxtaposes the growth in the number of state-chartered savings institutions regulated by the FDIC against the declining numbers of state-chartered savings institutions regulated by the OTS.

Analysis of the Demise

The demise of the state-chartered/OTS-regulated S&L was probably inevitable after the special powers enjoyed by these institutions were eliminated, as their cost of supervision was higher than that of federally chartered S&Ls. In fact, the federal charter might have displaced the state charter to an even greater extent than that noted above if not for two important changes. First, numerous states began to offer a savings bank charter in the early 1990s. Second, FIRREA allowed all S&Ls to change their charter to either a savings bank or a commercial bank charter. (Institutions that changed their charter were required to remain insured by the Savings Association Insurance Fund [SAIF] and were designated as Sasser banks.)[39] For S&Ls chartered in states that offered a savings bank charter, converting to that charter became a way to eliminate OTS supervision and the accompanying fees. In contrast to the demise of the state-chartered S&L, the population of state-chartered/FDIC-regulated savings banks increased substantially during the same period. Although their powers were also constrained by FIRREA, these institutions avoided supervisory costs at the federal level.

Between 1989 and year-end 2004, 350 savings institutions took advantage of the Sasser option to become state-chartered savings banks, regulated by the FDIC but insured by the SAIF. Figure 5

[39] See FDIC (1997), 133, footnote 181.

Figure 3

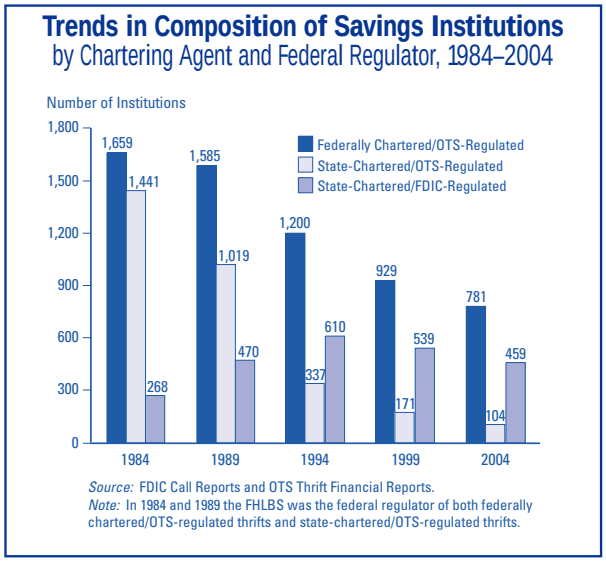
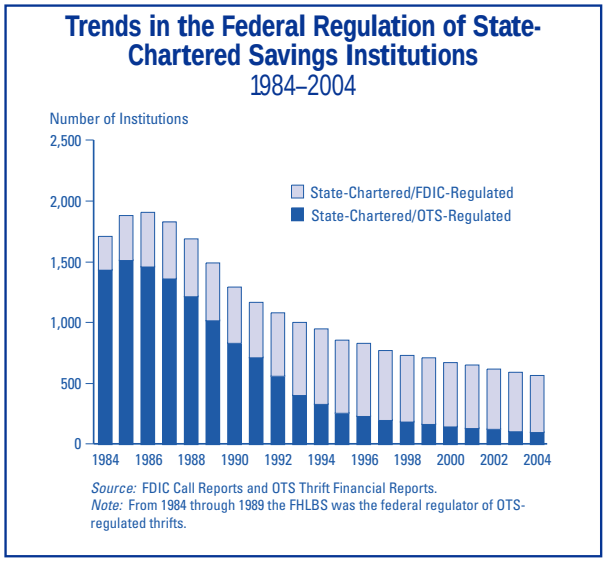


Figure 4



depicts this increase. One reason for these charter changes could have been a desire to escape the reputational effects of being known as an S&L after the bankruptcy of the Federal Savings and Loan Insurance Corporation. However, in the years following that bankruptcy, many S&Ls were able to change their name—and leave behind the reputational problems associated with the term S&L—without having to change their charter. A more likely cause of the growth in Sasser banks was the elimination of special powers enjoyed by state-chartered institutions coupled with the extra assessment cost that they could no longer justify.

Evidence on de novo thrifts also supports the belief that the double assessment coupled with the elimination of special powers played a role in the demise of state-chartered S&Ls. An analysis of the thrifts chartered after the passage of FIRREA shows that the majority were OTS charters (see figure 6). From 1989 through 2004, 34 institutions were chartered at the state level, and 33 of them chose to become FDIC-regulated savings banks; only one chose to become an OTS-regulated S&L.[40] By contrast, 147 institutions received OTS charters. Thus, 99.4 percent of thrifts chartered from 1989 to 2004 chose a charter that allowed them to avoid paying a double assessment.

These aggregate data have showed the importance of maintaining balance in the trade-off between powers and the cost of supervision in charter choice. The experiences of individual states show something more: the consequences for a dual chartering system when that balance disappears so that one charter becomes clearly favored over the other and there is no alternative. In California, for example, the imposition of a double assessment on state-chartered institutions and the absence of a state-chartered savings bank alternative have contributed to the demise of the state charter for thrifts. In 1984, 73 percent of California thrifts were state chartered; in 2004, there were no state-chartered thrifts. Conversely, the experience in Illinois illustrates that when there is an alternative, the state charter can remain a viable choice. In 1984, 44 percent of Illinois thrifts were state chartered, although no state savings bank charter was available. Following the enactment of FIRREA, Illinois created a state savings bank charter and institutions began to convert to Sasser banks. By 2004, the percentage of state-chartered thrifts had increased to 52 percent, with state-chartered savings banks dominating the mix—accounting for 88 percent of state-chartered thrifts.

[40] This institution voluntarily liquidated and closed in June 2003.

Figure 5

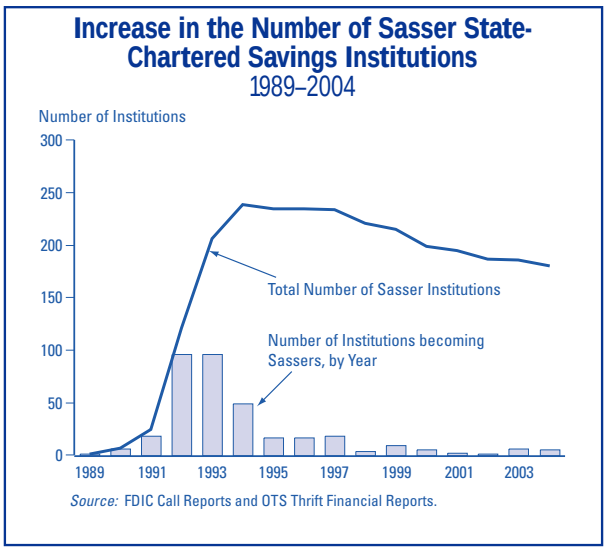
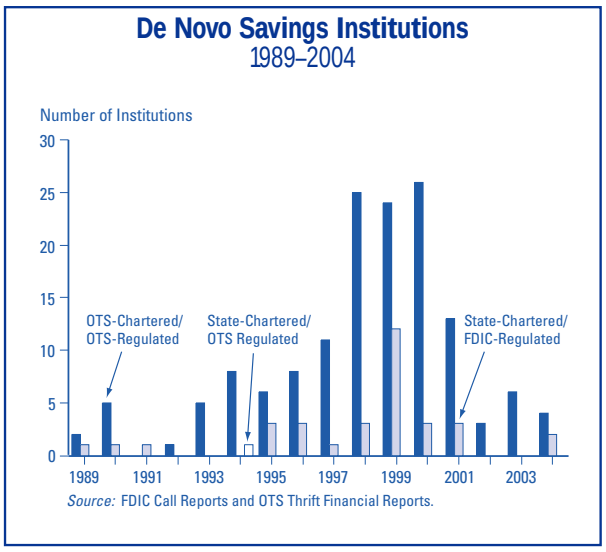


Figure 6



Charter Choice—Maintaining an Attractive Charter

The narrowing of differences in state and national bank charters has both simplified the process of choosing a bank charter and focused greater attention on how to remain a viable charter choice. For bankers, charter choice is now generally a question of whether the higher assessment cost associated with a national charter is offset by the benefits of operating under a single set of laws and regulations—the OCC's preemption authority. For bank regulators, charter choice entails working to contain the cost of supervision and finding alternative ways to make charters attractive.

For the public, the competition between federal and state bank regulators to offer an attractive charter and the choices that banks ultimately make will affect them in a number of ways. Concerns will be raised about the dual banking system's ability to generate adequate funding (and therefore whether there is an effective level of prudential supervision, especially in an era of larger and more complex banks). Concerns will also be raised about how consumer protection and other laws affected by preemption are applied and enforced. Ultimately, concerns will be raised about the long-term viability of the dual banking structure and whether such a system is still relevant.[41]

Switching Charters—A State Responds

The recent experience of New York shows the effects of the decision to switch charters on the chartering authorities. In July 2004, J. P. Morgan Chase & Co. and Bank One Corporation merged. The result was a combined company that had over one trillion dollars in assets, five banking charters (four national and one state), and operations in all 50 states. In November 2004, the charter of the lead bank, J. P. Morgan Chase Bank ($967 billion in assets), was converted to a national bank charter. As a result, the State of New York Banking Department (NYBD) lost significant revenue from supervisory assessments. In addition, HSBC Holding PLC had converted the New York charter of its lead bank, HSBC Bank USA ($99 billion in assets), to a national charter in July 2004. Together, the assessment revenue from J. P. Morgan Chase Bank and HSBC Bank USA had accounted for approximately 30 percent of the NYBD's operating budget.[42]

Before the loss of these two banks, the NYBD had already been working to change its funding mechanism. An NYBD study had found that state-chartered banks, which represented 10 percent of their state-licensed institutions, were carrying the department's entire budget.[43] The NYBD found it necessary to revise its assessment schedule and expand its assessment base. Effective with the 2005 fiscal year, the assessment base was revised to include all licensed and regulated financial institutions. For the first time, financial institutions other than banks paid annual fees for supervision in addition to any exam and licensing fees. The NYBD is also considering revising its charter to make it more attractive to banks and thrifts. In an attempt to modernize, the NYBD proposed the adoption of a wild-card statute that would convey federal bank powers to banks chartered in New York.[44]

Switching Charters—The OCC Responds

Although J. P. Morgan Chase Bank and HSBC Bank USA indicated their preference for a national charter, the OCC did not fare as well in the mid-1990s. For example, when The Chase Manhattan Bank N. A. completed its merger with Chemical Bank in 1995, it chose to retain Chemical's New York state charter. The loss of this large bank followed the loss of 28 banks under its

[41] In addition, concerns have been raised about the fairness of the current funding mechanism (especially to the extent that national banks may be said to subsidize state-chartered banks) and about the fairness of allowing national banks to disregard state laws that affect their operations.

[42] See State of New York Banking Department (NYBD) (2005), hereinafter, NYBD (2005).

[43] *American Banker* (2004). The New York Banking Department licenses and regulates over 3,500 financial institutions, including foreign and domestic banks, thrifts, mortgage brokers and bankers, check cashers, money transmitters, credit unions, and licensed lenders.

[44] NYBD (2005).

charter in 1994. Beginning in 1995, the OCC instituted a series of reductions in assessment fees and suspended the inflation adjustment factor in its 1995 assessment schedule. It continued to lower total assessments in 1996, and then in 1997, the OCC implemented a restructured assessment schedule to more accurately differentiate among banks and the resources they were likely to require in an examination. The number of national banks that switched charters declined after 1994, remaining at about 10 per year, until 2001 when the number again jumped.[45]

The conversion of J. P. Morgan Chase Bank to a national charter cited above also poses issues for the OCC. The charter switch brought additional assets under the OCC's supervision, and subsequently increased the agency's supervisory burden. The OCC indicated that additional supervisory resources would be focused on the risks posed by and across business lines. It planned to hire additional examiners and to increase its specialized supervisory skills in areas such as derivatives and mortgage banking—areas in which J. P. Morgan Chase Bank is highly active.[46] Revenues from the assessments paid by the bank will offset these increases in supervisory costs. However, whether the revenues will be enough is problematic as a one-to-one relationship does not necessarily exist between costs and revenues in the assessment schedule.

Approaches to Funding Bank Supervision

Following the increase in the number of banks switching charters in 2001, then Comptroller of the Currency, John D. Hawke Jr., began a series of speeches calling for reform of the bank supervisory funding system. Arguing that the viability of the dual banking system should not rest on the maintenance of a federal subsidy for state-chartered banks, he proposed that a new approach to the funding of bank supervision be found.[47] That new approach should "strengthen both the federal and state supervisory processes, protect them from the impact of random structural changes, and ensure that all supervisors, state and national, have adequate, predictable resources available to carry out effective supervisory programs."[48]

Passing the Cost through the Deposit Insurance Funds

Specifically, Hawke argued that if the costs of bank supervision were passed through the deposit insurance funds (for example, if the interest earned on the deposit insurance funds were used to pay for all bank supervision), the subsidy provided to state-chartered banks at the expense of national banks could be eliminated and at the same time an adequate source of funding for bank supervision could be ensured.[49] For this result to be achieved, all costs for bank supervision (costs of the states and the OCC) or some or all of the OCC's supervisory costs would have to be covered. In either case, the federal subsidy (that is, the national-bank subsidy) to state-chartered banks for the cost of bank supervision would be eliminated. The effect on the dual banking system is less clear. Once the states and the OCC were no longer competing for member banks on the basis of cost, the state charter might become relatively less attractive.

To discover the effects of funding total supervisory costs for the states and the OCC through the

[45] For a discussion of reasons behind charter switches see Whalen (2002) and Rosen (2005).

[46] *American Banker* (2005).

[47] Because state-chartered banks do not pay for federal supervision whereas nationally chartered banks do, it is argued that state-chartered banks are effectively subsidized by nationally chartered banks through the assessments that the latter pay to the deposit insurance funds. See Hawke (2000, 2001) and Rhem (2004).

[48] See Hawke (2001).

[49] Work on this article was completed prior to passage of the Federal Deposit Insurance Reform Act of 2005, which will merge the two deposit insurance funds. A variation on the above proposal would have the FDIC rebate to national banks–or through the OCC for pass-through to national banks–an amount equal to its contribution to the cost of state-bank supervision. Although the case can be made that nationally chartered banks have subsidized the FDIC's supervision of state-chartered nonmember banks, it would be difficult to calculate the precise size of that subsidy. An accurate accounting of the share of the deposit insurance fund(s) attributable to national banks would necessarily have to account for both premiums paid into the funds and the relative expense to the funds of national bank failures.

deposit insurance funds, we performed a sensitivity analysis of four large banks—two regulated by the OCC and two by the states—and an average community bank. The immediate effects would be twofold. First, the operating expenses of the FDIC would increase, which in turn would cause the reserve ratio—the ratio of the deposit insurance fund balance to estimated insured deposits—to be lower than it otherwise would be. Second, the assessment base for supervisory costs would be changed from assets to domestic deposits because deposit insurance premiums are assessed against domestic deposits. The incidence of the supervisory assessment would shift, falling more heavily on institutions funded primarily by domestic deposits. In other words, relying on the deposit insurance funds to cover the cost of bank supervision would change the basis on which supervision is paid and would therefore alter the allocation of cost among banks.

First we calculated the asset-based fee paid by these banks for supervision in 2002 (the latest date for which state assessment data were available). For the average community bank, we calculated this cost for three chartering authorities—the OCC, Georgia, and North Carolina. For 2002, the supervisory costs of the states and the OCC totaled approximately $698 million.[50]

If the FDIC had paid the cost of supervision for the OCC and the states through the deposit insurance funds, the five banks would have borne the cost on the basis of their domestic deposits rather than assets. To understand the effect that changing the assessment base could have on individual banks, we assumed that the total cost of supervision ($698 million) would be passed on to the banks. Under this scenario, a flat-rate premium assessment of 1.9 basis points (bp)—or about 2/100ths of a percent—of domestic deposits would be required.[51]

As table 4 shows, the incidence of the supervisory assessment shifts toward banks that have relatively high domestic deposit-to-asset ratios. Bank of America would have owed approximately $23 million more in assessments. By contrast, Citibank would have owed approximately $14 million less. For the average community bank, the difference would depend on its charter. If the bank were chartered in Georgia, its assessment would have declined by approximately $3,000, but in North Carolina, its assessment would have risen by approximately $5,000.

Although this approach would eliminate one inequity—the subsidization of state-chartered banks by nationally chartered banks—it would likely create others. First, assessment fees (and supervisory costs) vary considerably from state to state, and as a result, states with relatively high supervisory costs would benefit at the expense of states with lower supervisory costs. Second, funding supervision through the insurance funds would remove the incentives for the states and the OCC to keep their supervisory costs low. Third, the deposit insurance funds were designed for other purposes and therefore passing all supervisory costs through the funds would obscure the purpose of the funds.

Other Approaches to Funding Bank Supervision

Although Hawke's approach focuses on funding bank supervision through the use of the deposit insurance funds, other approaches exist. One suggestion would be to fund bank supervision through the Federal Reserve, another would be to alternate examinations between the OCC and the other federal regulators, and a third approach would be to develop an assessment schedule for bank examination at the federal level. These approaches are briefly discussed below.

[50] The costs for the OCC represent supervisory and regulatory costs as reported for 2002. To obtain approximate supervisory and regulatory costs for the states, we computed from the OCC data an average cost per $1 million of assets and then applied that to the assets represented by state banks. See OCC (2003a).

[51] In this scenario, it is assumed that supervisory costs would be funded in the same manner as shortages in the deposit insurance funds are currently handled. That is, the costs of supervision would be funded through a flat-rate assessment or surcharge that is levied against the assessable deposits–total (adjusted) domestic deposits–of each insured institution. The effect would be to replace the current regressive assessment system with a flat-rate assessment levied against domestic deposits. Modifications to this system could be made, if desired; however, in the interest of simplicity, we did not attempt to make any adjustments for bank risk or size.

One alternative approach is to fund bank supervision through the Federal Reserve. Banks do not earn any interest on funds they hold in reserve accounts at the Federal Reserve, and policy makers (including the Federal Reserve itself) have long advocated that interest be paid on required reserve balances—sterile reserves. In this suggestion, in lieu of paying interest on sterile reserve balances, the Federal Reserve could dedicate that implicit interest to cover supervisory costs for all banks. All banks are required to hold the same percentage of reserves on their deposits, so the incidence of this proposal would be neither progressive nor regressive, although banks that were especially reliant on deposits would be hit the hardest. In effect, a portion of the surplus that the Federal Reserve currently transfers to the U.S. Treasury would be diverted to cover the costs of bank supervision. For the same reasons as enumerated above, this proposal would likely eliminate one inequity but create others.

Another alternative is for the OCC and other federal bank regulators to rotate examination of nationally chartered banks, as is done with state-chartered banks. If this were done, state and national banks would be treated comparably, and the shared examination function would give the FDIC a better understanding of its risk exposure to national banks. A disadvantage, however, is that requiring multiple federal regulators to maintain the resources necessary to examine the same set of national banks would introduce inefficiencies to the supervisory process. And where the OCC uses a resident examination staff (as it currently does in 25 national banks), alternating exams with the FDIC (or the Federal Reserve) might be problematic. A second disadvantage is that the proposal does not resolve the cost competition between the OCC and the state bank chartering authorities.

The last approach we discuss is for the FDIC and the Federal Reserve to assess state-chartered banks directly for the cost of their supervision. To do this, the FDIC and the Federal Reserve would have to unbundle the cost of supervision from the cost of their other activities. In the case of the FDIC, the assessment it imposes on financial institutions could be broken into a deposit

Table 4

Comparison of Bank Supervisory Costs
Current Funding versus Funding by the Deposit Insurance Funds, June 2002

	Bank of America (OCC)	Citibank (OCC)	SunTrust Bank (GA)	BB&T (NC)	Average Community Bank[a]
Assets ($Millions)	$562,116	$487,074	$105,158	$58,156	$139
Domestic Deposits (DD) ($Millions)	$326,230	$103,347	$69,028	$33,082	$114
DD/Assets	58%	21%	66%	57%	82%
Annual Assessment Cost: Assets–rates set by chartering authority	$38,928,315	$33,974,793	$4,205,479	$1,982,180	OCC: $51,982 GA: $24,819 NC: $16,680
DD (1.9 bp)	$61,983,700	$19,635,930	$13,115,320	$6,285,580	$21,660
Incidence of Change in Funding Base	$23,055,385	($14,338,863)	$8,909,841	$4,303,400	OCC: ($30,322) GA: ($3,159) NC: $4,980
Percent change	59%	(42%)	212%	217%	OCC: (58%) GA: (13%) NC: 30%

Source: Data on deposits and assets are from the FDIC Call Reports and FDIC (2002b). Supervisory assessment schedules are from OCC (2002) and CSBS (2002). The calculations are approximations that do not reflect all the nuances inherent in the respective assessment schedules.

[a] "Average community bank" represents the weighted average of all banks with $1 billion or less in assets.

insurance component and a supervisory component. The deposit insurance component would be charged to all FDIC-insured institutions, and the supervisory component would be charged to institutions for which the FDIC is the primary federal regulator.[52] Similarly, the Federal Reserve could charge state-chartered member banks for their cost of supervision. To implement this proposal, the federal regulators could develop separate assessment schedules for each of their agencies, or they could work together to establish a single, uniform assessment schedule.

Proponents argue that the imposition of federal fees would end the federal subsidy of state-chartered banks. Opponents argue that the proposal would damage the dual banking system by eliminating one of its few remaining differences. Proposals to impose federal fees on state-chartered banks for their federal supervision have often been included in the annual federal budget process but Congress has routinely rejected them.

Conclusion

As the powers of state-chartered and national banks have converged, the number of reasons for a bank to choose either a state or a federal charter has declined. One of the few remaining differences between the charters is cost. In the competition between regulators for institutions, therefore, the cost of supervision has assumed greater importance, and in this area, state-chartered banks have the advantage. State-chartered banks generally pay lower exam fees, at least partly, because the federal agencies—FDIC or Federal Reserve—alternate examinations with the states and these federal agencies do not charge for exams. The OCC, and national banks, in contrast, must cover the full costs of bank examinations.

The thrift experience demonstrates how the choice of charter type can be influenced by changes in the balance between powers and the cost of supervision. When differences in the powers of state- and federally chartered savings and loans disappeared, the proportion of S&Ls with state charters changed dramatically. Many converted from an S&L charter to a savings bank charter. In states where this was not an option, the number of state-chartered S&Ls declined dramatically, almost disappearing.

Currently the higher supervisory assessments for national banks are offset by the preemption benefits that they enjoy. Conversely, state-chartered banks do not receive the benefits of preemption, but their supervisory costs are lower. As the situation is developing, the OCC is becoming the regulator of large, complex banks—banks that are likely to have an interstate presence and benefit from preemption. Smaller, more traditional banks continue to find the state charter attractive. Although both charters remain viable, a bifurcation within the dual banking system appears to be developing.[53] If either of these components is materially changed, then banks—like state-chartered S&Ls —may be induced to switch charters. The result may be to undermine the dual banking system.

Before any modification is made to the structure for funding bank supervision, a public-policy debate should be undertaken. Supervisors need a funding mechanism that reflects not only the costs they incur to supervise banks but also proves to be a stable source of funding in the long term. To this end, a number of proposals have addressed this issue. Each may provide a solution to the funding problem. However, given the few differences that remain between the bank charters, any change in the funding mechanism will affect the viability of the dual banking system. If the dual structure of the banking system still serves a purpose, then its disappearance should not be an unintended consequence.

[52] The FDIC engages in many activities currently included in its supervisory budget that are required for both its role as deposit insurer and its role as primary federal supervisor. The complete separation of these functions might be neither possible nor practical.

[53] See Jones and Nguyen (2005).

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APPENDIX
2002 Supervisory Assessment Schedules
Arizona, Massachusetts, North Carolina and South Dakota

Arizona Assessment Fee Structure

Annual assessment based on total assets as of June 30.

If total reported assets are		The assessment is		
Over ($ millions)	But Not Over ($ millions)	This Amount ($)	Plus	Of Excess Over ($ millions)
0	5	2,322		
5	20	2,322	0.000144	5
20	85	4,477	0.000113	20
85	200	11,848	0.000079	85
200	900	20,914	0.000067	200
900	2,000	67,786	0.000056	900
2,000	4,000	129,562	0.000050	2,000
4,000	6,000	228,922	0.000044	4,000
6,000		317,482	0.000039	6,000

- The Arizona State Banking Department is an independent agency.

- Examination fees and supervisory assessments are set by the commissioner and by statute. The commissioner determines how collected funds are allocated, appropriated, and spent. Assessments are levied annually.

- Additional hourly fees: $60 per hour per examiner for trust exams.

- Fee-sharing agreements: Permitted by the state; the Arizona State Banking Department has fee-sharing agreements with Alabama and North Dakota.

- Agreements to share examiner resources: The state of Arizona permits such agreements. The Arizona State Banking Department currently has none in place.

- Rebate authority: None.

Source: CSBS (2002).

Massachusetts Assessment Fee Structure

The Division of Banking uses a risk-based assessment system in which assessments are based on assets and CAMELS rating.

For banks with CAMELS Rating	For assets		The charge per $1000 is
	Over ($ millions)	But Less Than ($ millions)	This Amount ($)
1 and 2	0	10	0.3000
	10	50	0.1000
	50	250	0.0850
	250	5,000	0.0625
	5,000	30,000	0.0500
3	0	10	0.6000
	10	50	0.2000
	50	250	0.1700
	250	5,000	0.1250
	5,000	30,000	0.1000
4 and 5	0	10	0.9000
	10	50	0.3000
	50	250	0.2550
	250	5,000	0.1875
	5,000	30,000	0.1500

- Statute authorized the Executive Office of Administration and Finance to set examination fees and supervisory assessments. The Massachusetts Division of Banking has wide discretion over how collected funds are allocated, appropriated, and spent.

- Additional hourly fees: A per diem fee of $220 per examiner for nonbank licenses.

- Fee-sharing agreements: Permitted by the state; the Massachusetts Division of Banking has none in place.

- Agreements to share examiner resources: Permitted by the state; the Massachusetts Division of Banking has none in place.

- Rebate authority: None.

Source: CSBS (2002).

North Carolina Assessment Fee Structure

Annual assessment based on asset size.

For assets		The assessment is
Over ($ millions)	But Less Than ($ millions)	This Amount ($)
0	50	6,000
5	250	.00012
250	500	.00009
500	1,000	.00007
1,000	10,000	.00005
10,000		.00003

- The North Carolina Commissioner of Banks operates under guidelines set by the Department of Commerce and by state policies. Examination fees and supervisory assessments are set by statute. Any discounts or premiums from the statutory rate must be approved by the Commission. The Commissioner of Banks also determines how collected funds are allocated, appropriated, and spent.

- Additional hourly fees: None.

- Fee-sharing agreements: Not permitted by the state.

- Agreements to share examiner resources: Not permitted by the state.

- Rebate authority: None.

Source: CSBS (2002).

South Dakota Assessment Fee Structure

Semiannual assessment of 2.5 cents per $1,000 of total assets; Nondepository banks pay an additional $500 semiannually.

- South Dakota Assessment Fee Structure

- Semiannual assessment of 2.5 cents per $1,000 of total assets;

- Nondepository banks pay an additional $500 semiannually.

- Examination fees and supervisory assessments are set by the Banking Board and by statute. The Division of Banking's total budget is appropriated by the South Dakota legislature. Expenditures are approved by the Director of Banking. Assessments are levied semiannually.

- Additional hourly fees: None.

- Fee-sharing agreements: Permitted by the state; agreements are in place with Minnesota and North Dakota.

- Agreements to share examiner resources: Permitted by the state; agreements are in place with Minnesota and North Dakota.

- Rebate authority: None.

Source: CSBS (2002).