



Insight

Federal Reserve Must Supervise Small Banks Too

JUNE 4, 2010

On May 12th, the Senate overwhelmingly passed a bipartisan amendment to its financial reform legislation, restoring supervision of all bank holding companies (BHCs) to the Federal Reserve, and allowing state-chartered Federal Reserve System member banks to choose supervision by the Fed. The amendment, introduced by Senators Kay Bailey Hutchison (R-TX) and Amy Klobuchar (D-MN) and co-sponsored by 27 other Senators, passed by a vote of 90 to 9.

The amendment amounts to a major improvement to the Senate's "Restoring Financial Stability Act of 2010" and should be retained as part of the final reform legislation that emerges from the House-Senate conference committee later this month. The bill that cleared the Senate Banking Committee on a party-line vote (all Republicans voting "no") on March 22nd would have reduced the Fed's supervisory purview to only the 55 largest bank and thrift holding companies. To focus the nation's central bank exclusively on the activities, condition, and priorities of the very largest institutions would have increased regulatory arbitrage opportunities, introduced significant structural distortions into the financial marketplace, undermined the Fed's effectiveness as the nation's monetary authority - and cut to the very heart of American political economy.

The Federal Reserve Act of 1913 established the Fed's supervisory purview as all state-chartered banks that are members of the Federal Reserve System, of which there are currently about 850. The Bank Holding Company Act of 1956 permitted the creation of BHCs - there are currently more than 5,000 - and designated the Fed as their consolidated supervisor. Because more than 80 percent of all commercial banks in the United States are part of a BHC structure - including more than 75 percent of banks with total assets of less than \$100 million - by way of its oversight of BHCs the Fed maintains an active supervisory dialogue with large, medium, and small banks from which it derives a broad and balanced

understanding of banking system conditions.

The Senate Banking Committee's reform bill narrowed Fed supervision to only those bank and thrift holding companies with total assets greater than \$50 billion. Bank and thrift holding companies with total assets of less than \$50 billion would have been supervised by either the FDIC or the OCC, depending on the charter of the lead bank subsidiary. All state-chartered banks would have been supervised by the FDIC.

This proposed reshuffling of supervisor assignments would have entailed a number of serious problems. First, the \$50 billion threshold for determining the supervisory assignment of BHCs is entirely arbitrary and would create the opportunity for BHCs to choose between one of three regulatory agencies by either switching the charter of their lead bank subsidiary or by gaming the asset threshold – that is, by making growth and acquisition decisions not for business or economic reasons, but rather to be larger or smaller than \$50 billion. Second, over 4,950 BHCs – those with total assets less than \$50 billion – would be assigned to either the FDIC or OCC, neither of which has any institutional experience or expertise supervising BHCs.

More fundamentally, bank supervision is crucial to the Fed's effectiveness as the nation's monetary authority and lender-of-last-resort. Banks are the transmission belt of monetary policy and, therefore, first-hand knowledge of the activities, condition, and risk profiles of banks – through which the Fed's monetary policy decisions are implemented, or to which it might extend discount window lending – is essential.

But supervising large bank and thrift holding companies is not enough. Small and medium-sized banks play an enormously important role in our financial system and economy, serving the needs of most American small businesses, farmers, entrepreneurs, and households. Moreover, the needs and priorities of smaller banks frequently differ from large, internationally active institutions.

To be appropriate and effective for a national economy as large, complex, and diverse as the United States, monetary policy decisions must be informed by a balanced understanding of conditions across the banking system – which requires that the Fed maintain an active supervisory dialogue with banks of all sizes, not just the very largest. As Thomas Hoenig, president of the Federal Reserve Bank of Kansas City, stated recently, restricting Fed supervision to only the largest institutions “would transform the central bank of the United States into the central bank of Wall Street.”

Reducing the Fed's supervisory purview to the largest 55 institutions would also gut the Federal Open Market Committee (FOMC), which meets every six weeks to determine the

level of short-term interest rates. In establishing the Federal Reserve in 1913, policymakers constructed a system of 12 regional Reserve Banks presided over by a Board of Governors in Washington, and an FOMC comprised of the Governors and five of the regional Reserve Bank presidents on a rotating basis. This admittedly cumbersome system was deliberate – policymakers wisely sought to ensure that interest rate policy would not be dictated to the rest of the nation by urban interests and Washington, DC.

But mapping the location of the 55 largest bank and thrift holding companies reveals that more than half are headquartered in or near the cities of New York, Boston, and Chicago. Had the Senate Banking Committee’s proposal become law, nine of the 12 regional Reserve Banks would see the number of institutions they oversee fall from hundreds to five or fewer – likely not enough to warrant the operation of an independent Reserve Bank. Indeed, the number of banks supervised by two heartland Reserve Banks – Kansas City and St. Louis – would fall from 982 and 646, respectively, to zero. By reducing the Fed’s supervisory purview from roughly 6,000 institutions divided among the 12 regional Reserve Banks, to 55, the Senate Banking Committee’s bill would have destroyed the regional Reserve Bank system and shifted the overwhelming balance of monetary policy power to three large cities and Washington, DC.

The fundamental objective of financial reform is a financial system that is effective and efficient, flexible and resilient, that ensures institutional soundness and systemic stability, and that protects the interests of consumers, depositors, savers, and investors. Undermining the quality of bank supervision by dividing the nation’s BHCs between three different agencies, and undermining the effectiveness of the nation’s monetary authority, are outcomes clearly at odds with that fundamental reform objective.

Preserving the Federal Reserve’s supervisory authority over all BHCs, a structure that accounts for more than 80 percent of the nation’s banks – large, medium, and small – avoids unnecessary structural distortions, minimizes regulatory arbitrage opportunities, and ensures that monetary policy decisions will continue to reflect the diverse economic needs and priorities of the whole nation.