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RECENT CHALLENGES TO THE PERSISTENT DUAL BANKING SYSTEM

HEIDI MANDANIS SCHOONER*

INTRODUCTION

Take a moment sometime and attempt to explain to your spouse or child the dual banking system. Explain that if they want to open a bank, they can choose either a state or federal charter. If they choose a federal charter,¹ their regulator, whose headquarters is in Washington, D.C., would likely be more sophisticated and, perhaps, more stringent and detached. If they choose the state charter, their regulator would be more familiar with their community, more sympathetic to their business concerns and not nearly as far away. Customers would neither know nor care which charter they chose,² and regardless of their choice, customer's deposits would be insured by the FDIC.³

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1. The Office of the Comptroller of the Currency ("OCC") is the federal agency responsible for chartering and supervising all nationally-chartered commercial banks. 12 U.S.C. § 26, 93(a) (1994). The other federal banking agencies are: the Federal Deposit Insurance Corporation ("FDIC"), the Office of Thrift Supervision ("OTS"), and the Board of Governors of the Federal Reserve System ("Fed"). The FDIC is the primary federal regulator for state-chartered, commercial banks that are not members of the Federal Reserve System. 12 U.S.C. § 1813(q)(3) (1994). The FDIC also has the ability, under certain circumstances, to bring enforcement actions against any insured bank and its officers, directors and other affiliated professionals. 12 U.S.C. § 1818(t) (1994). The OTS is the primary federal regulator for savings associations. 12 U.S.C. § 1463 (1994). The Fed is the primary federal regulator for bank holding companies and state-chartered, commercial banks that are members of the Federal Reserve System. 12 U.S.C. §§ 248, 1844 (1994).

2. Most customers are also not aware that, until recently, interstate branching by banks was prohibited. Large banks did their best to let consumers believe that their bank operated in many states. In fact, however, these banks were simply operating (and many continue to operate) under common ownership of a bank holding company—the banks themselves were separately chartered in the respective jurisdictions in which they operated. True interstate branching is new to the banking industry. *See infra* Part III.

3. National banks and state banks that are members of the Fed are required to carry FDIC insurance; state banks that are not members of the Fed are not so required. 12 U.S.C. §

Archaic, arcane, or simply bizarre, the dual banking system—which allows a bank to be chartered and supervised by either federal or state authorities—is here to stay. Just as one hesitates before pulling on Superman's cape, bankers, bank regulators and legislators are reluctant to criticize the dual banking system.⁴ For various, and sometimes less than convincing reasons, the banking industry continues to hail the dual banking system as an integral part of the United States banking industry, entitled to the same deference as mom, baseball, and apple pie. Some scholars, however, remain skeptical over the need for this apparently inefficient structure.

Recent changes in the banking industry challenge some of the best of the justifications for the dual banking system. Still, the system persists and, although the balance of power between state and federal authority shifts toward the federal, the system does not appear to be in danger of extinction.

To clarify, the criticism is not aimed broadly at the dual system—rather, the state side of the dual banking system is vulnerable to attack.⁵ Either because of the national interest in the nation's financial system or the existence of federal deposit insurance, the federal side of the dual banking system is not subject to any threat of extinction. Therefore, the arguments in favor and against the dual banking system center on the proper role for states in the regulation of banks. This debate, however, is rarely heard in the halls of Congress. It is no small wonder that no one on Capitol Hill has spearheaded the demise of the dual banking system, since no significant constituency would be gained by doing so.⁶ Therefore, the dual banking system, for better or worse, is here to stay.

This essay continues with a brief discussion of the history of the dual banking system in Part I. Part II reviews the justifications for, and criticisms of, the dual banking system. Part III details the recent challenges to the dual banking system. Part IV looks to the future of the dual banking system and concludes that Congress has chosen not to preempt entirely the states' authority despite the continued erosion of states' authority over safety and soundness issues. This leaves the states with a continuing opportunity to serve as laboratories of innovation in bank regulation. If the states seize this opportunity, their role in the regulation of banks will persist inevitably regardless of political fortune.

1818(a)(1) (1994). For competitive reasons, however, few depository institutions operate without federal depository insurance at the present time.

4. Similarly, the dual banking system has been coined the "sacred cow" of bank regulation. Geoffrey P. Miller, *The Future of the Dual Banking System*, 53 BROOK. L. REV. 1 (1987).

5. This is somewhat remarkable since state banks were well-established prior to the creation of national banks. See *infra* Part I.

6. Congress, however, has passed legislation that would undermine the system. See *infra* Part III.

I. A BRIEF HISTORY OF THE DUAL BANKING SYSTEM

States began chartering banks long before the federal government entered that domain. When Congress created national banks in 1863, the dual banking system was the unintended byproduct.⁷ Congress passed the National Bank Act of 1863 to provide for a uniform national currency and to help finance the Civil War.⁸ The intent was not to create a dual banking system. Rather, the drafters of the legislation expected existing state banks to convert from state to federal charters.⁹ This arguably naive expectation never came to fruition.

When wholesale charter conversion failed to occur, Congress tried again. In 1865, Congress passed legislation imposing a prohibitive tax on state bank notes.¹⁰ State banks, however, avoided the tax by developing checking accounts—thereby eliminating the need for bank notes.¹¹ The tax on state banks, however, served as an incentive for new banks to seek national charters. Soon national banks began receiving charters and, in doing so, established the second side of the dual banking system, the national side.¹² It should come as no surprise that, based on this history of not so carefully executed long-term planning, the existence of the dual banking system has been labeled “an historical accident.”¹³

II. THE CASE FOR AND AGAINST THE DUAL BANKING SYSTEM

The dual banking system has endured since its creation in 1863. Although seemingly redundant, the existence of the system has been justified, *post hoc*, by many. One of the most often-cited defenses of the dual banking system is that it creates healthy competition between federal and state regulators.¹⁴ This theory posits that competition between regulators derives from banks' ability to choose between federal and state regulators as their charter-provider and primary regulator and banks' ability to convert from a federal to a state charter,

7. For comprehensive discussions of the history of the dual banking system, see Arthur E. Wilmarth, Jr., *The Expansion of State Bank Powers, The Federal Response, and The Case For Preserving the Dual Banking System*, 58 *FORDHAM L. REV.* 1133, 1152-55 (1990); Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 *CORNELL L. REV.* 677, 681-83 (1988); Miller, *supra* note 4, at 13-14.

8. Butler & Macey, *supra* note 7, at 681.

9. *Id.*

10. Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 *STAN. L. REV.* 1, 9 (1977).

11. Miller, *supra* note 4, at 14.

12. ROSS M. ROBERTSON, *THE COMPTROLLER AND BANK SUPERVISION: A HISTORICAL APPRAISAL* 54 (1995).

13. Butler & Macey, *supra* note 7, at 681.

14. Professor Scott's seminal article on the dual banking system explores the issue of regulatory competition in detail. Scott, *supra* note 10.

or *vice versa*, if dissatisfied with either regulator.¹⁵ Banks' ability to choose their regulator, arguably, pits federal and state agencies against one another, forcing them to alter regulatory practices and procedures to enhance their ability to attract and retain bank charters.¹⁶

Other justifications for the dual banking system are closely related. Sharing a common states rights theme, these defenses of the dual banking system are really justifications of the continued existence of state banks, rather than justifications of the dual system of banking. State regulators are deemed to be more in touch with the needs of their communities. James Watt, President and CEO of the Conference of State Bank Supervisors commented that: "State departments are on the ground. They know the bank, they know the management, they know the local community and they know the trends that are afoot in the state's economy."¹⁷ Generally, state legislators are also seen as more responsive to the needs of their constituents, particularly small banks.¹⁸ Similarly, and potentially most significantly, the dual banking system is credited with allowing for state and local innovation in financial services. A former Superintendent of Banks for New York State wrote: "It is here that bankers know the needs of their customers, the strength or weakness of their local economies and the products to offer to attract new business."¹⁹

The dual banking system is, however, far from being immune to criticism. While competition between regulators leads hypothetically towards more efficient (i.e., fewer and better) regulations, this type of competition has been criticized for creating "a destructive 'competition in laxity' between federal and state regulators that encourages regulators to neglect safety and soundness concerns in order to build their regulated constituencies."²⁰

Apart from whether competition between the regulators has positive or negative impacts on the banking industry, the theory of competition has been challenged by commentators who dispute the existence of a competitive environment.²¹ Professors Butler and Macey cite five "forces" that prevent regulatory competition:

15. *Id.* at 8-36.

16. *Id.* at 30-32.

17. James B. Watt, *The Dual Banking System Now More Than Ever*, Address at the Conference of State Bank Supervisors Annual Meeting and Conference 4 (April 15-18, 1994).

18. Robertson, *supra* note 12, at 8.

19. Jill M. Considine, *A State's Response to the United States Treasury Department Proposals to Modernize the Nation's Banking System*, 59 *FORDHAM L. REV.* S243, S244 (1991).

20. Wilmarth, *supra* note 7, at 1241. Professor Wilmarth asserts that the competition in laxity argument "overlooks the strong incentive of both elected public officials and appointed bank regulators to avoid bank failures." *Id.* at 1242.

21. Butler & Macey, *supra* note 7, at 693. Professors Butler and Macey argue, among other things, that the regulation of banks does not provide evidence of the existence of competition.

(1) the federal government's ability to preempt state regulations; (2) the federal government's provision of the only viable deposit insurance through the Federal Deposit Insurance Corporation—this leaves state banks subject to federal-FDIC regulation; (3) federal legislation, which, until recently prevented interstate banking; (4) the doctrine of "competitive equality," which limits national banks' activities to the activities permissible for state banks; and (5) state "wild card" statutes, which impose national bank regulations on state banks.²²

Recent efforts at coordination between federal and state agencies also suggests the lack of competition between them.²³

In addition to the arguments, discussed above, that the competition between regulators encourages lax regulations (or, more cynically, permits greater risk-taking), the dual banking system can be criticized for creating a costly system of overlapping regulation. State banks are subject to significant federal regulation, primarily because their deposits are insured by the FDIC.²⁴ The regulatory overlap means, for example, that state banks will be examined periodically by both federal and state authorities. This is costly for banks and their customers, who ultimately bear the burden of these costs. While federal and state authorities have made efforts recently to coordinate examination and supervision,²⁵ the overlap is far from being eliminated.

Finally, the dual banking system has been the subject of scholarly criticism because of the moral hazard created by the insurance of state banks' deposits by the FDIC. Under this theory, state regulators have less incentive to preserve the safety and soundness of state banks because the losses from state-bank failures are borne by the FDIC, not the state.²⁶ This theory, of course, does not take into consideration the strong incentive held by state regulators and bank officials to avoid bank failures,²⁷ not because of the direct financial impact on state coffers, but because of the political (i.e., loss of confidence in state regulators) and indirect economic (i.e., loss of jobs and a source of local financing) damage caused by the failure of a state bank. Nonetheless, our nation has recent experience with massive thrift failures, and the staggering burden borne by the nation's taxpayers.²⁸ As a result, it is difficult to equate the

22. *Id.*

23. *See infra* note 25 and accompanying text.

24. State banks may also be members of the Federal Reserve System and, as such, are regulated by the Board of Governors for the Federal Reserve System.

25. A State-Federal Working Group composed of state regulators and FDIC and Federal Reserve officials has been formed to "streamline and improve the coordination of the examination and supervision of state-chartered banks operating across state lines." Ellen C. Lamb, FDIC Press or "State-Federal Working Group" Release (Oct. 16, 1995). Efforts at coordination like these suggest an atmosphere of cooperation, rather than competition, between federal and state regulators.

26. Wilmarth, *supra* note 7, at 1241.

27. *Id.* at 1242.

28. The General Accounting Office recently estimated the cost of the S&L cleanup at

state regulator's or bank official's incentives for avoiding failure with the Federal Government's concerns for safety and soundness.

III. RECENT CHALLENGES TO THE DUAL BANKING

Despite continued declarations of support for the dual banking system by Congress and the federal regulators, recent and proposed changes in banking regulation could threaten the meaningful existence of the state-side of the dual banking system. While Congress has never attempted complete preemption of states' authority over issues relating to banking, the federal legislation of recent years proves that Congress is unwilling to leave the safety and soundness of federally insured banks to the state regulators.

In the wake of the bank and S&L failures of the 1980s and early 1990s, Congress passed far-reaching legislation in the hope of preventing future failures. That legislation, the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"),²⁹ with its focus on maintaining banks' safety and soundness, made significant changes affecting the vitality of the dual banking system. FDICIA amended the Federal Deposit Insurance Act³⁰ to limit, with certain exceptions, the activities and equity investments of state-chartered banks to those permissible to national banks.³¹ This portion of FDICIA impacts significantly the underlying premises of the dual banking system. FDICIA undermines competition between the regulators as the justification for the dual banking system, since the legislation contracted significantly the sphere of competition by preventing states from attracting bank charters by allowing broader activities or investments.³² Similarly, FDICIA

\$160.1 billion. *Financial Digest*, WASH. POST., July 13, 1996, at F1. The outcome of the Supreme Court's recent decision in *United States v. Winstar Corp.*, 116 S. Ct. 2432 (1996), added as much as \$20 million to the cleanup total. Jerry Knigh & Joan Biskupic, *High Court Ruling May Add Billions to S&L Cleanup Costs*, WASH. POST., July 2, 1996, at A1.

29. Pub. L. No. 102-242, 105 Stat. 2236 (1991) (codified in scattered sections of 12 U.S.C.).

30. Federal Deposit Insurance Act, ch. 967, 64 Stat. 873 (1950).

31. With respect to state banks' activities, the statute provides:

After the end of the 1-year period beginning on December 19, 1991, an insured State bank may not engage as principal in any type of activity that is not permissible for a national bank unless—(1) the [FDIC] has determined that the activity would pose no significant risk to the appropriate deposit insurance fund; and (2) the State bank is, and continues to be, in compliance with applicable capital standards prescribed by the appropriate Federal banking agency.

Id.

32. Even prior to FDICIA, federal regulators had the ability to limit, through their cease and desist powers, state banks' activities and investments to the extent that they were deemed to be "unsafe or unsound banking practices." 12 U.S.C. § 1818(b) (1992). For a general discussion of the federal regulators' cease and desist authority based on "unsafe or unsound banking practices," See Heidi Mandanis Schooner, *Fiduciary Duties Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175 (1995).

foils the states' role as laboratories of innovation as the basis for the dual banking system, as the act diminished states' ability to innovate, particularly in the area of permissible bank activities.

Congress appears more reluctant to preempt states' role in banking when the issues are not directly tied to safety and soundness.³³ With the passage of the McFadden Act in 1927, national banks were given the authority to open branches, but only to the extent that a state bank was so permitted.³⁴ This put the power to authorize or restrict branching in the hands of state legislators and regulators who, in turn, generally prevented out-of-state banks (both state and federal) from opening branches within their respective borders. This was an effective way for states to limit competition within their borders.³⁵ In 1994, The McFadden Act was repealed by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 ("IBBEA").³⁶ Under the IBBEA, unless a state opts-out by June 1, 1997, interstate branching by both national and state banks will be permitted within its borders.³⁷

Assuming that most states will not opt-out, Congress's push toward inter-

33. Of course, Congress has passed plenty of legislation that preempts state law on issues unrelated to safety and soundness. For example, the United States Supreme Court's recent decision in *Smiley v. Citibank*, 116 S. Ct. 1730 (1996), is a reminder of Congress's significant preemption of state law under Section 30 of the National Bank Act of 1864, Rev. Stat. § 5197, as amended, 12 U.S.C. § 85 (1994). Section 85 provides that a national bank may charge "interest at the rate allowed by the laws of the State . . . where the bank is located." 12 U.S.C. § 85 (1994). This provision allows a national bank to "export" the interest rate allowed by the bank's home state to customers residing in another state. *Smiley* expands a national bank's ability to export interest rates by upholding the Comptroller's interpretation of "interest" under the statute as including late fees charged to credit card customers. *Smiley*, 116 S. Ct. at 1730.

34. McFadden Act, ch. 191, 44 Stat. 1244 (1927) (codified as amended at 12 U.S.C. § 36 (1994)).

35. Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 702 (1988). In recent years, however, many states have chosen to open their borders to the growth of interstate banking by allowing out-of-state bank holding companies to acquire banks within their borders. See generally *Northeast Bancorp, Inc. v. Board of Governors of the Federal Reserve System*, 472 U.S. 159 (1985). While the bank holding company structure does not permit branching across state borders, it does permit the bank holding company, through its bank subsidiaries, to do business in more than one state. The inefficiencies generated by such a system are outside the scope of this essay.

36. Pub. L. No. 103-328, 108 Stat. 2338 (1994).

37. Specifically, the IBBEA permits the responsible federal banking agency to approve a merger between banks with different home states, unless the state of one of the home states "has enacted a law after September 29, 1994, and before June 1, 1997, that—(i) applies equally to all out-of-State banks; and (ii) expressly prohibits merger transactions involving out-of-State banks." 12 U.S.C. § 1831u(a) (1994). In addition, the IBBEA permits interstate branching through newly established branches if, inter alia, "there is in effect in the host State a law that—(i) applies equally to all banks; and (ii) expressly permits all out-of-State banks to establish *de novo* branches in such State." 12 U.S.C. § 36(g) (1994).

state branching illuminates the current status of the dual banking system.³⁸ Although Congress clearly expressed a strong desire for interstate branching through the passage of the IBBEA, it stopped short of usurping a state's right to decide whether interstate branching would be permissible within its borders.³⁹ This evidences Congress's continued respect for the states' role in regulating the banking industry.

Another byproduct of interstate branching relevant to the dual banking system is that it will most likely accelerate the current trend of consolidation in the industry. The number of banks in the United States has steadily decreased over recent years and will likely continue to decrease with the advent of interstate branching.⁴⁰ This alters, and possibly expands, the role of the state regulators since they now may play a role in supervising branches of out-of-state banks.⁴¹ In addition, the competition for banks charters may increase with the continued consolidation.⁴² As discussed in Part IV, however, it does not appear that this increased competition has extinguished the demand for state charters.

Other industry developments also impact the vitality of the dual banking system. The Comptroller of the Currency recently cited, as no longer relevant in America's twentieth century financial services industry: "the notion that *geography*—the physical location of a financial services provider or a financial transaction—forms the appropriate basis for determining what rules apply to the offering of financial services, and who applies those rules."⁴³ The reason

38. Most states have opted-in early, as permitted by statute, and only one state (Texas), has opted out so far. CONFERENCE OF STATE BANK SUPERVISOR, STATUS INTERSTATE BANKING LEGISLATION, (Sept. 23, 1996) (visited Feb. 6, 1997) <http://www.csbsdal.org/news_pr/96status.html>.

39. Congress, however, did limit the state's ability, as provided under the Douglas Amendment, to prevent out-of-state bank holding companies from acquiring banks within their borders. 12 U.S.C. § 1842(d) (1994). See *supra* note 37.

40. At the end of 1985, there were 14,417 insured commercial banks. By the end of 1995, there were 9,943 insured commercial banks. FDIC HISTORICAL STATISTICS ON BANKING 1934-1995: TABLE CB-1, (visited June 10, 1996) <<http://www.fdic.gov/research/sob/hist95/index.html>>.

41. The IBBEA provides that a state bank regulator may examine a branch operating in its state by an out-of-state insured state bank "for the purpose of determining compliance with host State laws, including those that govern banking, community reinvestment, fair lending, consumer protection, and permissible activities; and . . . to ensure that the activities of the branch are not conducted in an unsafe or unsound manner." 12 U.S.C. § 1820(h)(1) (1994). If the state bank regulator finds a violation, the regulator may institute enforcement proceedings "as would be permitted under the law of the host State as if the branch were a bank chartered by that host State." 12 U.S.C. § 1820(h)(2) (1994).

42. Last year, however, 102 commercial banks received charters. This is the largest number of commercial bank charters since 1991. Ricki Helfer, FDIC Chairman, Remarks Before the Conference of State Bank Supervisors, Conference on Interstate Banking (Feb. 2, 1996).

43. Eugene A. Ludwig, Comptroller of the Currency, Remarks Before the Jerome Levy

cited by the Comptroller for the irrelevancy of geography is the growth of technology in financial markets, i.e., e-money and e-banking.⁴⁴

Consumers know that both their charge card (which is often operated by an out-of-state bank), automated teller machine card, or even their checks may be accepted across the country and around the world. Customers do business with their banks, thrifts or credit union by mail, telephone or computer modem from every conceivable location. Consumers see their bank's logo in numerous states. Thus, the states' traditional geographic control over banking, i.e., control over the operation of banking within their borders, is becoming less relevant in today's market. As discussed above, Congress has historically and recently allowed states to prohibit out-of-state banks from doing business within their borders. To the extent that the importance of a location of a bank, i.e., its headquarters or its branches, is fading in the eyes of the consumer, Congress's deference to the states on this issue is becoming less meaningful.

Finally, efforts at consolidation of the federal banking regulators are seen as a threat to the dual banking system. Consolidation of the federal banking agencies may entail consolidating some or all of the functions of the FDIC, the Fed, and the OCC into one agency. The federal entity that would be responsible for supervision of state-chartered banks would also be the entity in charge of the supervision and chartering of national banks.⁴⁵ The fear is that the consolidated banking regulator may have an institutional bias in favor of national banks over state banks.⁴⁶ In the Fall of 1993, the Clinton Administration proposed the creation of a federal banking commission that would regulate all FDIC-insured depository institutions and their holding companies.⁴⁷ Criticism

Economics Institute (April 12, 1996).

44. Eugene A. Ludwig, Comptroller of the Currency, Remarks Before the ABA Conference on Financing Commerce in Cyberspace, Washington, D.C. (May 8, 1996).

45. Today, these functions are handled separately. The FDIC has primary supervisory responsibility for state banks that are not members of the Federal Reserve System. The Fed has primary supervisory responsibility for state banks that are members of the Federal Reserve System. The OCC has primary supervisory responsibility and chartering authority for national banks. *See supra* note 1.

46. The National Governors Association warned: "The charterer of national banks cannot be given oversight of state-chartered banks, or the result will be a bias toward national bank requests and issues." Robert M. Garsson, *Governors' Stand on Preserving Role of States Heartens Foes of Agency Consolidation Plan*, AM. BANKER, Feb. 8, 1994 at 4. The American Bankers Association and The Bankers Roundtable have expressed similar concerns. *Bank Trade Groups Voice Concerns Over Regulatory Consolidation*, 1536 Fed. Banking L. Rep. (CCH) 9 (February 25, 1994). *See also*, Catherine A. Ghiglieri, *Superregulator Dooms Dual Banking System*, AM. BANKER, Mar. 9, 1994 at 7; Barbara F. Bronstien, *Dual System Is Seen Threatened, Resilient*, AM. BANKER, April 20, 1994 at 6.

47. For a summary of the proposal, see 1649 Fed. Banking L. Rep. (CCH) ¶ 89,593 (May 3, 1996). The Administration's proposal would have created a new Federal Banking Commission. Recently, Administration officials have recommended delaying action on agency consolidation pending Congress' resolution of proposed expansion of banks' securities and insurance

over the effect of the administration's proposal on the dual banking system, among other criticisms, spurred the Department of Treasury to amend the proposal to protect the interests of state-chartered banks.⁴⁸ This provides another example of the political power of the proponents of the dual banking system. The fate of proposals for consolidation is unknown at this time. It is likely, however, that any future proposals will contain some concessions to state-chartered banks.

IV. THE FUTURE OF THE PERSISTENT DUAL BANKING SYSTEM

Despite recent threats to the dual banking system, it persists. While the state-side of the dual banking system has appeared most vulnerable to extinction, recent evidence suggests otherwise. From 1991 to 1994, more banks switched from national to state charters than from state to national charters.⁴⁹ In 1995, out of the 102 commercial banks that received charters, seventy-five percent chose state charters.⁵⁰ This suggests, at the very least, that the states are holding their own in the competition for bank charters. The analysis, however, might differ if the size of the institution were taken into account. The majority of state banks are smaller institutions. In other words, most larger institutions choose national charters.

The fees charged by the OCC are a source of the imbalance in conver-

powers. *Bank Regulators Urge Congress to Delay Agency Consolidation* 1649 Fed. Banking L. Rep. (CCH) 1 (May 3, 1996). Congress, however, continues to receive recommendations for consolidation. The General Accounting Office recently proposed consolidated supervision of banks and thrifts to the House Committee on Banking and Financial Services. James L. Bothwell, Director of Financial Institutions and Market Issues, Testimony Before the House Committee on Banking and Financial Services GAO/T-GGD-96-117 (May 2, 1996). With regard to agency consolidation, Mr. Bothwell provided the following recommendation:

Reduce the number of federal agencies with primary responsibilities for bank oversight: We believe that a logical step in consolidating is to combine the Office of Thrift Supervision (OTS), the Office of the Comptroller of the Currency (OCC), and FDIC's primary supervisory responsibilities for state-chartered banks that are not members of the Federal Reserve into a new federal banking agency or commission. . . . This new independent agency, together with the Federal Reserve, could be assigned responsibility for comprehensive, consolidated supervision of those banking organizations under their purview, with appropriate functional supervision of individual components.

Id.

48. The amended proposal provided that the Federal Banking Commission would rely on the results of state examinations for well-capitalized banks with assets of less than \$250 million. *Treasury Announces Changes to Regulatory Consolidation Plan*, 1537 Fed. Banking L. Rep. (CCH) 1-2 (Mar. 4, 1994). In addition, the FDIC would continue its role of approving the activities of state-chartered banks—a power that would not be given to the Federal Banking Commission. *Id.*

49. Justin Fox, *Stampede Toward State Charters Makes the OCC Change Its Tune*, AM. BANKER, Aug. 28, 1995, at 3.

50. Helfer, *supra* note 42.

sions.⁵¹ Fees are important in charter choice for smaller institutions.⁵² The states charge significantly lower fees to the banks they supervise than the OCC charges to national banks.⁵³ The OCC, however, has made recent efforts to reduce its fees. If the OCC is successful, lower fees may no longer provide state regulators with a means for attracting bank charters.

Without congressional intervention, however, the OCC will experience difficulty cutting its fees enough to become competitive with state regulators who have much lower overhead. For example, state regulators often rely on the FDIC or the Fed to conduct examinations of their banks.⁵⁴ This contributes to the lower fees charged by state regulators to their banks. State banks may not retain this advantage. The Clinton Administration, as part of a seven-year balanced budget proposal, proposed that state banks be charged for the examinations by the Fed and the FDIC.⁵⁵ While this proposal is not currently under consideration, it could resurface in future efforts to raise federal revenues.

Another factor contributing to the recent preference for state charters by some bank managers is the perception that the OCC's examiners are tougher on their banks. Regardless of whether or not this is actually true, it seems logical that banks might have less difficulty working with an examiner who is a resident in their state and more familiar with the local economy than a national bank examiner who may be less sympathetic to local idiosyncrasies. As discussed above, however, "geography" is becoming less and less important in the banking industry. As financial services become more and more globalized, local idiosyncrasies may become less relevant to the business of banking.⁵⁶

For the reasons discussed above, the issue of fees and the examiners' sympathy for local concerns may prove ephemeral. Moreover, many of the tradi-

51. *Id.*

52. Eugene A. Ludwig, Comptroller of the Currency Testimony, Remarks Before the Committee on Banking and Financial Services of the U.S. House of Representatives (April 30, 1996).

53. Watt, *supra* note 17 (state fees run approximately one-half of the fees paid by national banks) (transcript available from author); see also Kenneth Cline, *Atlanta's Bank South Applies for Conversion To a State Charter*, AM. BANKER, June 22, 1995 at 4 (Chief Executive Officer of Bank South found it 50% less expensive to operate under a state, as opposed to national, charter). But see James B. Arndorfer, *More Calif. Groups Abandoning State Charters*, AM. BANKER, October 23, 1995, at 11 (reporting on California credit unions switching to federal charters to avoid state taxes).

54. Fox, *supra* note 49.

55. *Administration Proposes Changing State Banks for Exams* 1630 Fed. Banking L. Rep. (CCH) 1 (Dec. 21, 1995).

56. Of course, many smaller banks are counting on the existence of a market for local banking services to stay in business. Their hope is that there will always be a core of small business customers and individual consumers who would prefer to do their banking business with a smaller institution run by local managers.

tional justifications for the dual banking system discussed in Part II can be dismissed as merely theoretical or at best uncertain.⁵⁷

The future of the dual banking system lies most logically in states' continued efforts at innovation.⁵⁸ In the past, states have served as the forerunners to important developments in the banking industry. States must continue to innovate or their role in the financial industry may become, at best, ceremonial. While Congress is not likely to leave issues directly relating to the safety and soundness of financial institutions to the states, Congress has never shown a desire to preempt comprehensively the states' role in the supervision of financial institutions.

One area that appears ripe for state activism is the improved delivery of financial services to underserved neighborhoods. Congress enacted the Community Reinvestment Act ("CRA") "to encourage [financial] institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions."⁵⁹ The CRA, however, has been subject of much criticism and invitations for reform.⁶⁰ Moreover, only a handful of states have enacted their own laws addressing community reinvestment.⁶¹ It is difficult to imagine an area of financial services regulation that should be of more interest to the states, i.e., how financial services are delivered in their own neighborhoods.⁶² Arguably, as multi-state banks grow, interstate branching spreads, and bank holding companies increase their market share, the need for CRA-type initiatives becomes even more critical. Innovation in this area would benefit not only the localities intended as beneficiaries, but may provide empirical evidence that would facili-

57. For example, the existence and/or benefits of competition between the regulators is uncertain. See *supra* notes 14-28 and accompanying text.

58. Ricki Helfer, Remarks at the Conference of State Bank Supervisors Annual Meeting and Conference (May 4, 1996) (visited Oct. 25, 1996) <gopher://gopher.fdic.gov:70/00/press/speech/4may.txt>.

59. 12 U.S.C. § 2901(b) (1994).

60. See generally Andrew Miller, *The New York Proposal to Revise the Community Reinvestment Act: A Qualitative Step Towards Objectivity and Effectiveness*, 43 CATH. U. L. REV. 958-80 (1994).

61. *Id.* at n.127.

62. Congress recently recognized the importance of states' authority in issues of community reinvestment. The IBBEA provides with regard to interstate branching that:

The laws of the host State regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches shall apply to any branch in the host State of an out-of-State national bank to the same extent as such State laws apply to a branch of a bank chartered by that State, except—(i) when Federal law preempts the application of such State laws to a national bank; or (ii) when the Comptroller of the Currency determines that the application of such State laws would have a discriminatory effect on the branch in comparison with the effect the application of such State laws would have with respect to branches of a bank chartered by the host State.

12 U.S.C. § 36(f)(1) (1994).

tate reform of the CRA.

CONCLUSION

The states' role in the chartering and supervision of banks does not face a current threat of eradication. The states' role, however, continues to evolve. With a heightened federal attentiveness to the safety and soundness of federally-insured institutions, because of the hard lessons learned from the S&L crisis, the states' role on issues relating to banks' safety and soundness is diminished by federal preemption. Generally, however, Congress has not extended preemption broadly into other areas of bank supervision.

The fact remains that the United States banking system would continue to function, if not thrive, without the dual banking system. While the dual banking system serves no *necessary* purpose, the benefit of the system lies in the opportunities for innovation that the system provides and, perhaps even encourages. For this benefit to be meaningful, states must actively pursue opportunities for innovation. Continued, and perhaps increased, innovation by state regulators and legislators would provide a concrete, as opposed to sentimental, basis for the preservation of the dual banking system.

