Comptroller of the Currency
Administrator of National Banks

Reforming the FUNDING OF BANK SUPERVISION

July 2001

Introduction

This paper addresses a fundamental flaw in our system of bank supervision — the way supervision is funded. It also offers a proposal for fixing this flaw. The proposal not only would enhance the resources available to assure quality supervision of our nation's banking system, but would reduce the assessments now imposed on both national and state banks to pay for their own supervision — with no additional cost to taxpayers.

Background

Under the present system, national banks pay the full costs of their supervision, through assessments levied on them by the Office of the Comptroller of the Currency (OCC), the federal agency that charters and supervises national banks.

State-chartered banks, by contrast, pay only for that small fraction of their supervision that is provided by state supervisory agencies. The predominant part of state bank supervision actually comes from two *federal* agencies, the Federal Reserve System (FRS) and the Federal Deposit Insurance Corporation (FDIC).[1] These federal agencies perform exactly the same supervisory functions for state banks as the OCC performs for national banks. The main difference is that the FRS and the FDIC do not assess state banks for the costs of their supervisory services.

In 2000, these two federal agencies spent almost $1 billion on state bank supervision, none of which was recovered from the banks they supervise.

[1]The FRS supervises state banks that have elected to become members of the Federal Reserve System. The FDIC supervises federally insured nonmember state banks.

The current situation is a problem that Congress needs to fix because:

It's Unfair. The present system is doubly unfair to national banks: they not only are fully charged for the costs of their supervision, but they also have contributed a substantial portion of the deposit insurance premiums that the FDIC relies on to fund its supervision of state nonmember banks. The present system also unfairly imposes on taxpayers and on the FDIC insurance fund the costs of federal supervision of state banks.

It Distorts the Dual Banking System. Healthy competition in the quality of supervision and innovation in meeting the needs of banks and their customers should lie at the heart of our dual banking system. Unfortunately, today a primary focus of this competition is on price. Because state banks receive a federal subsidy for the predominant part of their supervision, there is a cost incentive for banks to avoid or depart from the national charter in favor of the heavily subsidized state charter. This inevitably tends to undermine a vigorous and healthy dual banking system.

It Compromises Safety and Soundness. The present system of funding bank supervision works pro-cyclically. It threatens national banks with additional cost burdens in times of economic stress, and it imposes constraints on supervisory resources at the very time they are most likely to be needed. When there is widespread stress in the banking system, as there was in the late 1980s and early 1990s, significantly increased supervisory attention is demanded and supervisory costs rise. As this occurs, healthy national banks, which already pay more than their state counterparts, face the prospect of substantial increases in assessments to pay the costs of more intensive supervision of problem banks. This creates a strong incentive to convert to a state charter. Such conversions, in turn, reduce the resources available to OCC to fund increased supervisory needs.

It's Inconsistent with Deposit Insurance Reform. A fundamental principle at the heart of deposit insurance reform is that subsidies should be eliminated. Healthy, well-managed banks should not be required to bear the costs and risks presented by less well-managed, riskier banks. By the same token, national banks should not be forced to bear the costs of supervising and insuring state banks. Any proposals to reform the deposit insurance system must inevitably come to grips with this inequity in the system, just as they must focus on such fundamental issues as the appropriate size of the insurance fund and how rebates, if any, should be distributed. Since the principal purpose of bank supervision is to protect the insurance fund, the manner in which supervision is funded is inextricably bound up with the subject of reform of the deposit insurance system.

The following discussion elaborates on each of these points.

The Present System is Unfair to National Banks and to Taxpayers

The three federal bank supervisory agencies — the OCC, the FRS, and the FDIC — perform virtual identical functions with respect to the banks they supervise, as is demonstrated by Table 1. Indeed, for more than 30 years, whenever Congress has enacted new bank regulatory laws,

Table 1 **The Federal regulatory agencies have similar supervisory responsibilities.**

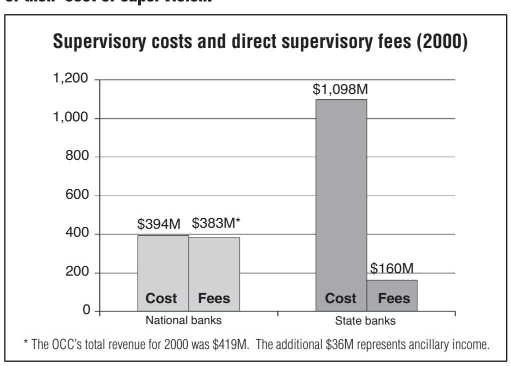
Responsibilities	OCC	FDIC	FED
Safety and soundness exams	X	X	X
CRA Exams	X	X	X
Fair Lending Exams	X	X	X
Enforce Bank Secrecy Act	X	X	X
Regulation	X	X	X
Entry	X	X	X
FFIEC	X	X	X
Enforce the Securities Exchange Act of 1934	X	X	X
Branch Applications	X	X	X
Merger & Consolidation Applications	X	X	X
Enforce Capital Requirements and PCA	X	X	X
Truth in Lending Act Examinations	X	X	X
Right to Approve Directors and Senior Execs	X	X	X
Authority to Prescribe Oper and Mgrl Stds	X	X	X
Supervisory Enforcement Actions	X	X	X
Supervise Foreign Activities	X	X	X

6/14/2001

it has almost always parceled out identical supervisory and enforcement responsibilities to the three federal agencies. As a result, the FRS and the FDIC today perform the predominant part of state bank supervision.

Yet the burden of funding supervision falls with vastly disproportionate weight on national banks. As shown in Table 2, virtually the entire amount of the cost of national bank supervision in

Table 2 **Supervisory fees paid by national banks cover 100% of their cost of supervision. Supervisory fees paid by state banks cover 15% of their cost of supervision.**



6/14/2001

2000 was borne by national banks. By contrast, only 15 percent of the total cost of state bank supervision — that is, the costs of both state and federal supervisors — was paid by state banks, in the form of assessments by their state supervisors. The lion's share of these costs — 85 percent — reflecting the costs of the FRS and the FDIC, were absorbed by those federal agencies.

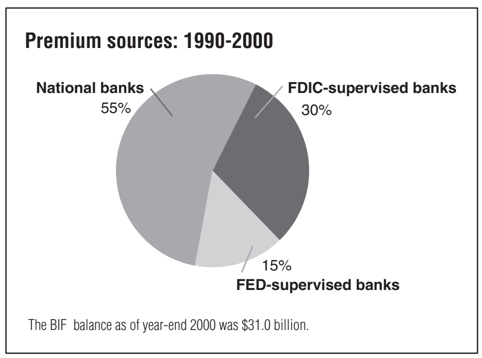
To understand how this federal subsidy unfairly impacts taxpayers and national banks, it is important to understand how the FRS and the FDIC are funded and how those funds are spent.

The FRS derives most of its revenues from open market operations — that is, from the earnings on its portfolio of government securities. Any portion of those earnings remaining after the FRS subtracts its costs of operation are paid over to the U.S. Treasury for the benefit of taxpayers. In 2000, the FRS spent about $300 million (out of $31 billion in total revenue) on its supervision of state banks. Thus, the costs of supervision of state banks by the FRS are, in practical effect, borne by all American taxpayers.

The FDIC's operating revenues are taken out of the deposit insurance funds, which have been built up over the years through the payment of premiums by all insured banks. In 2000, the FDIC tapped into the funds for a total of $1.2 billion, of which $638 million was spent on the supervision of state banks. Of this amount, $568 million was attributable to the FDIC's supervision of state-chartered commercial banks, and $70 million to its supervision of state-chartered thrift institutions.

As the holders of the largest share of the nation's bank deposits, national banks have always been the largest contributors to the bank insurance fund, and therefore to FDIC revenues. As shown in Table 3, national bank contributions today account for almost 55 percent of the funds in the FDIC's

Table 3 **Over one-half of the premiums paid into the bank insurance fund since 1990 came from national banks.**



6/14/2001

Bank Insurance Fund — and, by extension, 55 percent of the earnings that are used by the FDIC to supervise state nonmember commercial banks. ***In other words, 55 cents of every dollar expended by the FDIC on state nonmember commercial bank supervision is attributable to payments by national banks.***

To be sure, state banks have contributed to the insurance funds just as have national banks. *But the fact remains that state banks receive their federal supervision free of cost, while national banks bear the full cost of their supervision.*

There is no justification for a federal policy that subsidizes state banks, yet leaves national banks to bear the full cost of their supervision. Such a policy is especially unwarranted when the majority share of that subsidy is involuntarily funded by national banks through their contributions to the FDIC insurance fund.

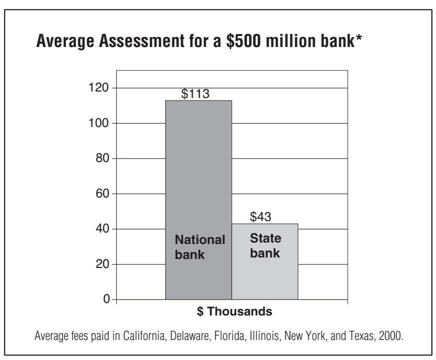
The Present System Undermines the Dual Banking System

Historically, the choice between a national or state charter centered on such things as supervisory philosophy and responsiveness, examination quality, and the scope of permissible activities. The cost of supervision was generally a minor factor. But that's no longer the case.

Today the costs of supervision have increased by orders of magnitude, largely because of laws that Congress has put in place over the past three or four decades to strengthen supervision and to increase protections for consumers — laws that Congress has charged the *federal* supervisors with the responsibility for enforcement. Since the FRS and the FDIC absorb those costs for state banks, while the OCC must pass them on to national banks, the disparity in supervisory costs paid by state and national banks has increased commensurately.

Thus, as shown in Table 4, state banks today pay supervisory costs on average less than half of what comparably sized national banks pay.

Table 4 **Because state banks pay only for supervision costs incurred by states, their supervisory fees average less than half those of national banks.**



6/14/2001

To compound the unfairness, many state bank supervisors today actively proselytize for charter conversions on the basis of the fee differential, in effect exploiting the value of the subsidy provided to state banks by the taxpayers and the FDIC. Thus, the fee disparity creates a significant incentive for a banker to choose a state over a national charter — to opt, in effect, to be the recipient, rather than the donor, of a subsidy.

If large numbers of banks were to make that choice — and the current pressures for cost reduction gives them a strong incentive to do so — the national bank charter could be seriously undermined. The result, perversely, would ultimately be to *increase* the cost to taxpayers and the insurance fund, since banks that convert from national to state charters would no longer pay the full costs of their federal supervision, and it would fall to the FRS and the FDIC to pick up *all* of the additional supervisory costs.

The Present System Compromises Safety and Soundness

The current funding system works pro-cyclically to *reduce* supervisory resources precisely when they are most likely to be needed and to increase the cost burdens on national banks at the very time they are grappling with an economy under stress. Of all the perversities in our system, none is more serious.

We saw this process at work during the wave of large bank failures in the late 1980s and early 1990s — a period of stress in the banking system not seen since the Great Depression. Supervisors were under mounting pressure to monitor and manage the crisis. Yet each bank failure translated into a reduction in the base on which assessments could be levied to support the agencies' increased costs. At the OCC this meant significant increases in assessment rates — 14 percent in 1989, another 11 percent in 1991, and a whopping 30 percent in 1992.

Assessment rates were subsequently lowered when the crisis subsided and the industry returned to health. But it is unfair that our system requires well-managed banks to provide the additional supervisory resources needed to deal with problem institutions. *This is a flaw in the system that must be addressed*.

Moreover, even in times of relative economic calm, the present system can adversely affect the supervision of national banks. Given the concentration of assets in the banking system today, the loss of even a single large national bank — whether due to merger, conversion, or failure — could have a huge impact on the OCC's operating budget. Faced with the loss of a substantial part of its assessment base, the OCC would have only two choices: either to reduce its supervisory resources or to increase assessments on the remaining institutions.

State bank supervisors face a similar problem. In almost half the states, a single bank accounts for 25 percent or more of the asset base on which state supervisors base the assessments they need to fund their offices. Thus, the loss of such a large bank could have a crippling effect on a state supervisor's ability to provide quality supervision.

Deposit Insurance Reform Offers an Opportunity to Mend the Present System

A fundamental principle on which all of the current proposals for deposit insurance reform are based is that cross-subsidies in the system should be eliminated. Banks should contribute to the insurance funds based on the risks they present, and healthy banks should not be required to bear the costs and risks of providing deposit insurance to poorly managed, troubled banks.

Eliminating the fee disparity between national and state banks is an inextricable component of deposit insurance reform. National banks have, in effect, been forced to contribute more to the deposit insurance fund than they rightfully should, because more than half of their contributions to the fund go not for insurance coverage, but to defray the FDIC's costs of supervising state banks. *Any proposal to reform deposit insurance must deal with this cross-subsidy as much as it must deal with the risk subsidy provided by less risky banks*.

The FDIC's initiative to review and revise the deposit insurance system has focused on a number of fundamental issues relating to such questions as how deposit insurance premiums should be set, what the appropriate size of the deposit insurance funds should be, and how rebates, if any, should be distributed once the size of the fund exceeds some specified limit. Although some aspects of the FDIC's proposal are controversial, the debate over deposit insurance reform has been characterized by broad agreement that any reform program should advance the goals of efficient and equitable distribution of the costs and benefits of deposit insurance.

In that context, it's particularly important that we address the supervisory funding issue. *As long as premium income or the revenue it generates is used to fund the federal supervision of only one part of the industry, the FDIC's deposit insurance premium structure — even a revised one — cannot equitably price insurance coverage*. Remedying this inequity and separating the actual costs of the FDIC's supervisory functions from the costs of providing deposit insurance is an essential step toward efficient and rational pricing of both.

How to Fix the Problem

Any proposal for reform of our system of supervisory funding must pass several basic tests. It should

- Strengthen both the federal and state supervisory processes, and protect them from the impact of random structural changes in the banking system;
- Enhance the *qualitative* aspects of competition within the dual banking system;
- Promote a fair and efficient deposit insurance system, and
- Ensure that all supervisors, state and national, have adequate, predictable resources available to carry out effective supervisory programs.

While there have been many different proposals to those ends, we believe that the most straightforward solution would be to develop a common approach to funding supervision. Since effective supervision is a critical component of a sound deposit insurance system — and since state nonmember supervision is already funded from the FDIC insurance fund — it makes sense to extend the existing arrangement to cover the costs of both state *and* national bank supervision from the FDIC fund. In other words, instead of funding supervision through direct assessments on banks, it should be funded by payments to supervisors — the OCC and state supervisors — from the insurance fund, to which *all* banks contribute.

How Would It Work?

Under a proposal the OCC has developed, the costs of both national bank supervision by the OCC and state bank supervision by the states would be paid from the FDIC insurance funds, as follows:

- Working with the FDIC, the OCC and state supervisors would jointly develop a formula for allocating funding based initially on current levels of funding.
- The formula would take into account both the number of institutions and total assets under supervision, as well as the financial condition and growth of the institutions.
- In subsequent years, the baseline allocation would be no less than the supervisors' costs for the preceding year, unless the baseline were adjusted to take account of changes in relevant factors.
- In no event would allocations exceed the investment earnings of the insurance funds for the preceding year. If earnings were insufficient to cover the baseline allocations, payments would be reduced pro rata. No payments could be made from the funds' principal.

- The agencies would retain the authority to impose supplemental assessments on their banks to meet unusual demands.

In short, this proposal would transfer the direct costs of supervision from the assessment process to the insurance funds — which, of course, have been built up by the very same banks that have paid national and state assessments.

The proposal would not involve any new costs for state banks. Indeed, the proposal envisages that assessments on state banks would be eliminated or reduced significantly.

Can the Funds Afford It?

It is clear that the FDIC funds could easily carry the costs of these allocations. In fact, the Bank Insurance Fund (BIF) alone could support the additional OCC and state supervisory costs. Today BIF holds over $31 billion in assets. Over the past five years, BIF's investment income — that is, excluding any premium income — has averaged more than $1.6 billion a year, or nearly 140 percent of the *combined* 2000 supervisory expenses of the OCC, FDIC, and the 50 state supervisors. Thus, even in the absence of premium payments, BIF is currently generating more than enough investment income to defray the supervisory expenses of the OCC and the states, and the FDIC as well.

What Benefits Would It Bring?

There would be enormous benefits to such a new approach to the funding of supervision, with no perceptible downside. Specifically,

- It would place supervision on a sounder and fairer footing, relieving national banks of the burden of subsidizing their state bank competitors, without threatening FDIC resources.
- It would be a step toward allocating the costs and benefits of deposit insurance in an equitable and efficient manner, thus facilitating deposit insurance reform.
- It would ensure that all supervisors have the resources necessary to provide effective bank supervision, regardless of changes in the economy or the structure of the banking system.
- It would revitalize the dual banking system to move beyond the current charter price competition and recapture the elements of the dual banking system that have made it vital to the fabric of our nation's banking system: creativity, efficiency, and healthy competition.