

Remarks by
John D. Hawke, Jr.
Comptroller of the Currency
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It's a pleasure once again to be a participant in the University of North Carolina School of Law's Banking Institute, being offered for the first time under the auspices of the new Center for Banking and Finance. The Center's commitment to teaching, scholarship, and service to the banking and law communities will be of immense value -- and a source of immense pride -- to North Carolina and the whole nation in the coming years. I congratulate the faculty and staff who have worked so hard to transform the Center from a vision into a reality.

The last time I was with the Institute was in Chapel Hill, and I spoke to you then about financial modernization and the legislation that went on to become the Gramm-Leach-Bliley Act of 1999. Since we have decamped to Charlotte for this program, it seems fitting to turn to a subject that, for many, virtually defines this great city. That subject is consolidation in the financial services industry -- a trend that gave impetus to GLBA, and that has, in turn, been given impetus by it.

The FDIC recently released its "Quarterly Bank Profile," covering the last three months of 2000, and that report reminded us again of how far industry consolidation has come. In 1985, there were no fewer than 14,400 insured commercial banks in the United States. That number has shrunk every year since then, leaving us with around 8300 banks today. And of course this shrinkage understates the true level of merger and

acquisition activity, for the aggregates include the new charters that are added to the system each year.

Closer inspection of the FDIC's latest numbers actually reveals some slowdown in the rate of consolidation from the frenetic pace of earlier years, and that trend also seems likely to continue for some time. It may be related to the slowdown in the economy or it may simply indicate that the industry is still busy digesting earlier acquisitions -- or both. But I have not heard anyone suggest that we've finally reached critical mass, and, with more than 8000 independent banks still on the scene, there seems to be ample opportunity for further consolidation to occur.

If history is a guide, North Carolina will be in the forefront of whatever innovations are in the industry's future. This is a safe prediction now, but who would have predicted 15 or 20 years ago that Charlotte would become one of the world's great banking centers -- or, indeed, that the structure of banking in the United States would look like it does today? So much has changed over that time that it's easy to forget what the banking landscape looked like before the leaders of Charlotte's banking community set out to transform it.

Twenty years ago, banking was essentially a local business. Indeed, a guiding principle for antitrust analysis of bank mergers, first articulated by the Supreme Court in the mid-1960s, was that banking markets are primarily local in character. That principle was buttressed by pervasive legal constraints designed to prevent the geographic expansion of banks -- constraints that protected competitors, but deprived banking customers of the efficiencies of open markets and real competition. During the 1980s, those barriers started to fall as leaders like Hugh McColl and Ed Crutchfield brought their

intellect, imagination, and energy to bear on the business. Because of their vision -- and their relentless pursuit of a competitive marketplace -- we have today a genuinely national, and enormously competitive, banking system. Charlotte has become one of its capitals.

Those who opposed these efforts and sought to retain the insulation from competition that banks had traditionally enjoyed argued that a more consolidated industry would be unresponsive to local needs and impossible to supervise. But neither concern has been borne out. Changes of name and ownership involve adjustments on all sides, but most customers have found that they now enjoy the best of both worlds -- personalized, highly responsive service and access to a comprehensive range of financial products. For example, the evidence suggests that small business loans and financing for community development projects are more readily available now than they ever have been. And where there was any basis for believing that a merger might result in less responsiveness to local needs, new entrepreneurs have been quick to enter the market with newly chartered institutions.

For our part, I believe that regulators have demonstrated over time that we're fully capable of adapting to the supervisory challenges presented by a restructuring industry. Today large bank supervision has become a continuous process rather than an episodic event. In our large bank program, which covers almost 30 of the country's largest banks, we now maintain full-time teams of resident examiners, who cover not only basic safety and soundness supervision, but all of the other specialties, as well -- capital markets, compliance, asset management, MIS, and so on. More than 350 dedicated OCC examiners and support staff -- men and women specifically trained to identify and

address the existing and emerging risks associated with complex banking organizations -- staff our large bank program, which has been widely studied and emulated by other U.S. and many foreign bank supervisory agencies. With this experience in supervising large, complex banking institutions, I'm confident that our capabilities are equal to whatever supervisory challenges a consolidating industry poses in the years ahead -- just as they have been in the past.

However, there is an Achilles heel in our supervisory system, and it's a vulnerability that's grown increasingly troublesome as the industry confronts a possible turn in the economy, and that is the way in which supervision is funded. It was considered quite a significant reform when, back in the early twentieth century, the country converted from an arrangement under which banks paid a flat fee for their examinations to one that assessed banks on a sliding scale based initially on their total capital and then on their assets. That reform eliminated the incentive for examiners to cram as many exams as possible into a workweek in order to maximize their income.

This change also introduced other, less desirable incentives. For a long time, higher supervisory assessments were considered a small price to pay for growth, and banks paid them, for the most part, without a second thought. But two recent developments changed that. First, a more competitive financial marketplace and intensifying cost pressures have made bankers more attuned even to relatively small opportunities for savings. Second, and more important, we have seen a change in the nature of the competition for membership that lies at the heart of our dual banking system. Traditionally, a banker's choice between a national or state charter centered on such qualities as supervisory philosophy and responsiveness, examination quality,

permissible activities, and cost. But with the narrowing of differences between the powers available to state and national banks, in large part due to state wild-card statutes, and with the lessening of burdens on state banks' interstate operations brought about by parity legislation and by agreements among the states, that competition has focused more and more on assessments and the cost of supervision.

This has had both positive and negative consequences. On one hand, sensitivity to supervisory costs has encouraged the OCC and state supervisors to be extremely careful about their spending. Efficiency has long been heralded as a major advantage of the dual banking system, and there's little doubt that the burdens of supervision, financial and otherwise, might be greater but for the responsiveness of the OCC and state supervisors to the need to be more efficient. Of course, the most substantial portion of the costs of supervising state banks are those of the Federal Reserve and the FDIC, who perform for state-chartered banks exactly the same functions that OCC performs for national banks, but without imposing any charge for their services, as must the OCC. Because those agencies are essentially self-funded -- unlike the OCC, which is almost totally dependent on the assessment revenue it collects from national banks -- they are not subject to the external pressures for efficiency that work alike on state supervisors and the OCC.

Still, it has to be recognized that the effectiveness of supervision can suffer, and serious inequities can result, if these pressures get out of hand. Consider, for example, what happened during the wave of large bank failures in the late 1980s and early 1990s -- a period of stress in the banking system that had not been seen since the Great Depression. Excruciating demands were placed on supervisors to staff up in order to

manage the exigencies of a banking system under severe pressures. Yet just as these demands were being felt, the system was contracting as banks failed, thereby reducing the base on which fees could be increased to support the increased costs. At the OCC this meant significant increases in assessments -- 14 percent in 1989, another 11 percent in 1991, and a whopping 30 percent in 1992. To be sure, there was a series of reductions in subsequent years, but one conclusion is inescapable: well-managed banks -- the survivors -- were forced to bear significant additional costs to support the supervisory resources needed to deal with problem institutions. This is a perversity in the system that must be addressed before we experience any repeat of the conditions that created such pressures.

Even in good times there are perversities in an assessment-based system of funding supervision. The restructuring of the industry over the past 15 years, for example, has had adverse effects on both the OCC and state bank regulators. Every time there is a merger between a state bank and a national bank, one or the other system will lose a member -- and the larger the bank, the larger the loss of revenue. Even apart from mergers, where a large multibank holding company with banks in several states "rolls up" its subsidiaries into a single bank with an interstate branch network -- something that's happening ever more frequently since the passage of the Riegle - Neal Interstate Banking and Branching Efficiency Act of 1994 -- there will be a loss to either system. The OCC's assessments will be diminished because marginal assessment rates decline as the size of the consolidated bank increases. And in the case of a state bank "roll up," each state in which a separate charter previously existed other than the home state of the consolidated bank will lose dues-paying members.

The effect of these changes on state banking systems, which already spread their expenses over a smaller base of institutions, can be very significant. In 24 of the 50 states, a single large state-chartered institution accounts for 25 percent or more of all state chartered assets -- and, presumably, more than 25 percent of the total assessment revenues of the state banking authority. Thus, the loss of a large state bank in those states has the potential for significantly weakening the support for state bank supervision.

A healthy system of state bank supervision is very much in the national interest -- not only to maintain a vigorous and dynamic dual banking system, but also to protect important federal interests, for the federal "safety net" stands behind all insured banks, irrespective of charter. Thus, to paraphrase John Donne, don't ask for whom the bell tolls when a large state bank exits the state system: it tolls for all of us.

The question, of course, is what to do about this. I have already stated publicly that the direct imposition of new federal fees on state banks is not a politically viable approach -- even though there is no basis for justifying the federal subsidy that is presently delivered by the Fed and the FDIC. I believe we must come up with a new method of funding bank supervision -- a method that will 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.

There are a number of alternative approaches that one might consider, and I believe that now is the ideal time to do so, as the whole topic of the role of deposit insurance is being reexamined. An idea that I think has considerable appeal would draw on the earnings of the FDIC's insurance funds to defray the costs of both state and

national bank supervision. Today, with the funds aggregating about \$41 billion, and generating earnings of more than \$2 billion per year, there would be considerably more funds available to defray the costs of FDIC, OCC, and state supervision than those agencies today spend in total. Working together, and using the present costs of supervision as a baseline, state and federal supervisors could develop an allocation formula that would reflect not only the breadth of responsibilities of the agencies, but the condition, risk profile, size, and operating environment of the banks they supervise. All agencies would remain free to impose supplemental assessments if they chose, but competitive pressures would presumably work to keep these charges at a minimum.

This arrangement would offer several meaningful advantages. First, it would remedy the inequity to national banks that exists today, resulting from the fact that the FDIC already funds its supervision of state banks out of the earnings of the deposit insurance funds, to which all banks have contributed. We estimate that national banks account for 52 percent of the contributions to the bank insurance fund since the resources of that fund were exhausted in 1991. Considering that the FDIC spent about \$590 million on state nonmember bank supervision in 1999, national banks can be viewed as having contributed about \$300 million to the FDIC's costs of supervision -- this in addition to the \$384 million in assessments they paid to the OCC for their own supervision.

Of course, there are other roads we might take to placing our supervisory funding on a sounder and fairer basis. The inequity of requiring national banks to pay a share of the cost of supervising state-chartered banks could be remedied by having the FDIC return to national banks -- or to the OCC, for pass-through to national banks -- that portion of their insurance premium that is currently diverted to supervision. Such an

approach would get national banks out of the business of subsidizing their competitors, with relatively minor impact on FDIC resources.

But ending this anomaly is not just a matter of fairness to national banks. The very constructive debate now taking place on the future of deposit insurance, and the role that a truly risk-based system of insurance can play in bank supervision, has stressed the importance of allocating the costs and benefits of insurance in an equitable and efficient manner. 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.

There's a second major advantage of a system under which the OCC and the state supervisory agencies would be funded out of the earnings on the insurance funds. I believe it would reinvigorate the dual banking system. Although there has always been an assessment differential between state and national charters -- and, given the federal subsidy to state banks, it has often been substantial -- most banks are likely to choose their charters more on the basis of such non-financial factors as regulatory philosophy, access, and the perceived quality of supervision. Indeed, the size and health of the national banking system is testimony to this conclusion. Banks would still be free to choose under the system I've described, but those factors would almost certainly loom larger in a regime that was more equitable with regard to supervisory charges, and that encouraged competition in those qualities that are more relevant to a safe and sound banking system.

The devil is always in the details, of course, and obviously the approach I've suggested this evening is little more than that -- a concept that requires a full airing and

fleshing out. That's what I'm proposing to begin today. I would like to stimulate a broad dialogue among all of the interested parties and policy makers. Through such a dialogue, I believe we can develop concrete proposals to overhaul the current system, and replace it with one that supports rather than undermines our ability to achieve common goals.

There's no doubt in my mind that we have the tools and the expertise to effectively supervise the banking industry of today and tomorrow, whatever form it takes. That's especially true if all who play a role in our supervisory system work and compete constructively and not at cross-purposes. The time to start is now.