Comptroller of the Currency
Administrator of National Banks

PUBLIC AFFAIRS

September 9, 2003

Remarks by John D. Hawke, Jr.

Comptroller of the Currency

Before **Women in Housing and Finance**

Washington, D.C.

I'm delighted to appear before this distinguished group once again. This is my third outing with Women in Housing and Finance as Comptroller of the Currency. In my past visits with you I have spoken about the dual banking system and preemption. And just so you won't think I am losing my focus, I want to speak today about – preemption and the dual banking system.

In my last talk, about a year and a half ago, I detailed the historical roots of preemption, reminding that this is a doctrine that has its origins in the Supremacy Clause of the Constitution and the landmark 1819 Supreme Court decision in *M'Culloch* v. *Maryland*. The principle that the states cannot constitutionally restrict the powers of entities created under federal law has been a bedrock precept of federalism for more than 180 years. It has had special importance for the national banking system – a system that was created by Congress to advance the **national** interest in a uniform and nationwide system of federally chartered financial institutions.

The federal courts have consistently applied this principle over the years, and a wide variety of state laws have been held constitutionally inapplicable to national banks. Indeed, so clearly established is this principle that when we recently issued an order preempting the Georgia anti-predatory lending law, the Georgia Attorney General declined the opportunity to take us to court. The State AG informed the State Banking Commissioner, after conducting a thorough review of the precedents, that "state regulation of national banks has been severely limited by federal law" and "so long as the OCC's legal conclusions are related to the banking activities of national banks [its] decision will be difficult to challenge successfully." The AG was absolutely correct in this judgment. In fact, the last time an OCC position on preemption was rejected by a federal court was the Court of Appeals decision in the *Barnett* case—which, of course, was reversed by the Supreme Court of the United States and subsequently reaffirmed by Congress in the Gramm-Leach-Bliley Act.

Against this background, the recent clamor we have been hearing about OCC actions on national bank preemption is really quite surprising – surprising not only because of its utter disregard of history and precedent, but because of its unusually intemperate tone. For example, one State Attorney General has attacked the OCC for sticking "a dagger in the heart of federalism." Another, with a proclivity for making headlines, has charged us with "unrelenting efforts . . . to undermine the states' ability to protect their citizens." A consumer advocate has accused the OCC of being "out of control" – a particularly startling charge in light of the stream of recent federal court decisions upholding our positions. And even my good friends at the Conference of State Bank Supervisors (CSBS) have accused us of hatching a dark conspiracy to create "a whole new financial regulatory structure without any democratic debate or process."

It's easy to dismiss these extravagant and meritless statements as a kind of constituent posturing. But the simple fact is that OCC has been doing nothing new. We are **not** engaged in a campaign to obliterate federalism or to create a new financial regulatory structure, and we have just as much interest in the protection of consumers as any State AG. Far from being "out of control," we are fully subject to judicial review, and those unhappy with our decisions seem to have no hesitation in taking us to court – where our record of success has been overwhelming. We have simply been applying long settled – and constantly reinforced – principles of federalism, and we have been doing so with great regard for the interests of consumers.

What **is** truly surprising – and worthy of serious note — is that it has been the **states** that have persistently ignored the mandates of federalism. Notwithstanding the fact that "state regulation of national banks has been severely limited by federal law," as the Georgia AG forthrightly recognized, we see state after state passing laws intended to limit the powers and regulate the business of national banks. These include such laws as those that would regulate the fees that national banks may charge, the services they must provide, the attributes of various kinds of loans they make, their ability to act as fiduciaries, and even their right to do business in the state. We routinely prevail when these laws are challenged on preemption grounds.

We also see efforts by State Attorneys General to assert enforcement authority directly against national banks — notwithstanding two very clear federal statutes vesting in the OCC exclusive visitorial powers with respect to national banks. When we met with a group of State AGs earlier this year to discuss their ambitions in this regard, they asserted that because of their nationwide networking ability they could be more effective than the OCC in bringing national banks to heel – a proposition with which, as you might expect, we vigorously disagreed.

In truth, the attack on the "heart of federalism" is coming from the states, not from us.

I think it is fair to ask what is going on at the state level. Why are the states now becoming so aggressive in seeking to assert authority over federally chartered institutions? Why are they now trying to undermine the distinctions between state and national banks that go to the heart of the dual banking system?

One obvious answer is that there is enormous political appeal in doing so. For example, no one likes to pay a fee for the use of an ATM, so a law prohibiting banks from charging fees for the use of their ATMs by individuals who are not their customers is undoubtedly going to be very popular — never mind that the predictable result of such laws is likely to be that banks will shut off access to their ATMs by non-customers. And what better pose for a crusading enforcer aspiring to greater glory than to be seen as a basher of big banks.

Of course, it is not that state legislatures or AGs are unaware of the underlying principles or precedents. Many of the state laws that purport to apply to national banks are drafted with express "preemption parity" provisions that operate to make the law inapplicable to state banks if it is preempted for national banks. The Georgia anti-predatory lending law had such a provision, as have others, such as the ATM surcharge laws that were the subject of earlier litigation. The inclusion of these provisions reflects a clear awareness by these legislatures that by extending coverage to federally chartered institutions, preemption is likely – that they are walking on thin legal ice. But by this means state lawmakers can effectively cover all the bases: they satisfy consumer interests by passing broadly applicable, politically popular laws, while regarding the interests of local state chartered banks by automatically rendering the law inapplicable to them if it should be held inapplicable to national banks.

One would wish for a better-informed understanding of the law on the part of State AGs. Yet the law on visitorial powers could not be clearer. Since the earliest days of the national banking system, federal law has provided that no national bank shall be subject to any visitorial powers except as authorized by federal law, vested in the courts of justice or directed by Congress – and Congress has never vested such powers in State law enforcement officials. Indeed, in the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994, Congress explicitly addressed the question of the applicability of host state consumer protection laws to branches of national banks that are established interstate — laws regarding community reinvestment, consumer protection, fair lending, and interstate branching. It said that such state laws apply to such national banks branches in the state, **except** when they are preempted by federal law, and it further provided that the enforcement against a national bank of any such state law that was **not** preempted was the exclusive domain of the OCC. Current efforts to enforce such state laws against national banks simply fly in the face of Riegle – Neal.

Of course, the OCC shares a common interest with state law enforcement authorities in the protection of customers of national banks, and we would hope that cooperation, rather than competition, would characterize our relationships. To this end we have adopted special procedures at the OCC to handle referrals of consumer complaints from State AGs and state banking departments. I have personally sent letters to the State AGs describing the new processes we have put in place in order to work cooperatively **with** them. I have also invited the State AGs to enter into a cooperative arrangement with the OCC that would be embodied in a memorandum of understanding setting up a framework for addressing consumer protection issues relating to national banks. I regret to say that to date we have had no response to our invitation, only rhetoric. If the interest of consumers **were** paramount, as they should be, one might expect that a proposal such the one we have made would be embraced rather than ignored.

I should also point out that, at least in the area of predatory lending, which is where most of the current controversy seems to focus, the state AGs themselves have recognized that federally regulated banks are not the problem. In an **amicus** brief filed recently in connection with litigation over an Office of Thrift Supervision (OTS) preemption regulation, 22 State AGs (including the two I quoted earlier) stated unequivocally that, based on their investigations and enforcement actions, “predatory lending abuses are largely confined to the subprime mortgage lending market and to non-depository institutions,” and “not banks or direct bank subsidiaries.”

In an earlier letter to the OTS, 46 State AGs stated: “In the experience of the state Attorneys General, predatory lending is perpetrated primarily by non-depository lenders and mortgage brokers,” which “unlike depository institutions, are subject to little regulation by . . . federal agencies.”

In light of these statements, the charge that OCC preemption actions constitute an “unrelenting effort” to undermine state consumer protections has to be seen for what it is – inflated and hollow rhetoric.

Despite the hyperbole about undermining state consumer protections, any fair examination of the record should make clear that the OCC can and will move vigorously to remedy abuses. We have a world-class, best-in-the-business Customer Assistance Group that last year helped to process more than 79,000 cases. We have taken significant enforcement actions to require restitution to consumers who have been injured by abusive practices. We have defeated the strategy of payday lenders to use national banks as a cover for evading state consumer protection laws. And we have issued the most comprehensive supervisory guidance ever issued by any federal banking agency – and, I suspect, any state agency – defining and describing predatory lending, warning banks about the supervisory consequences of engaging in such abusive practices, and stating that if we find predatory practices in a national bank it will reflect adversely on their CRA ratings – something no one else has ever done.

To be fair to CSBS, I suspect their recent remarks were addressed not so much to preemption generally – the principles with which CSBS has long been familiar — but more to our position that national bank preemption extends to operating subsidiaries of national banks. It was more than two years ago that the OCC codified our position on this issue in a rule, and since that time we have had two federal court decisions sustaining our position. Since operating subsidiaries have long been recognized as the corporate equivalent of divisions of the bank itself, and since they can perform only activities eligible for the bank itself to perform, it is exceedingly difficult to see what the rationale is for treating them differently from the bank for preemption purposes, and our regulation simply reflects this principle. While we may have a difference of view on this issue, I think it is rather excessive to charge that we are engaged in an effort to create "a whole new financial regulatory structure without any democratic debate or process."

This rising chorus of complaints from the states, and the increasingly aggressive posture of state legislatures and enforcement authorities with regard to national banks, gives me another cause for concern, because I believe they may mask serious underlying problems in the dual banking system. Indeed, these problems could prevent the dual system from functioning in the future in the essential role it has played in our economy over the past 140 years.

The driving dynamic of dualism, of course, is freedom of choice. Implicit in choice is the existence of meaningful differences. In times past, there have been significant differences between the national and state charters – differences reflecting supervisory philosophy, supervisory responsiveness, examination quality, and the scope of permissible activities. But today truly meaningful differences are increasingly difficult to find, and the **states** are largely responsible for this.

Consider the question of permissible powers and activities. State supervisors pride themselves on being laboratories of innovation. And, indeed, many staples of banking practice, from checking and NOW accounts to mortgage loans, were first introduced by state-chartered institutions. But where has the innovation been in recent years? Indeed, I think the most significant of the **recent** innovations coming out of state banking departments has been the continuing effort to afford state banks the same opportunities as national banks. For example, 47 of the 50 states have passed some form of "wild card" law, automatically authorizing for state banks many of the powers and activities permitted for national banks.

This same motivation – emulation rather than innovation — has been present in the interstate branching context, where state supervisors have worked creatively to try to secure for state banks some of the natural advantages that accrue to national banks. Recognizing that national banks would likely be able to operate under a single set of rules when branching interstate, state authorities obtained federal "parity" legislation providing that host state laws would apply to local branches of out-of-state state banks only to the same extent they would apply to an out-of-state national bank.

And recognizing that state banks branching interstate might be faced with the need to deal with multiple state regulators, while national banks answered only to the OCC, state supervisors adopted a protocol under which they agreed that the home state supervisor would have the basic responsibility for supervising the interstate branches of their banks. These were creative steps that addressed the need to maintain competitive equity, but they did not reflect the spirit of innovation of which state supervisors were so proud. In the face of some recent indications that CSBS's interstate protocol might be feeling some internal stresses, as some individual states have taken different views of their own interests, it is striking that state supervisors are now seeking robust **federal** legislation that would define the respective powers and responsibilities of home- and host-state supervisors with respect to the supervision of state banks branching interstate. What are we to say about federalism and the dual banking system in a world of "wild cards" and parity laws, a world in which state authorities have to resort to **federal** laws to sort out their respective **state** jurisdiction?

More to the point, what do the state systems offer in the way of real charter choice to financial institutions in a world in which the objective seems to be to blur any charter distinctions that hold any competitive significance? What happened to state systems as "laboratories of innovation"?

Earlier this summer, a CSBS witness stated, in Congressional testimony supporting continuing preemption of state laws under the Fair Credit Reporting Act (it seems federal preemption is not **always** bad), that "state bank supervisors are strong advocates for a system that allows the states to serve as laboratories for innovation and change, not only in bank powers, but also in the area of consumer protections." But where has innovation in consumer protection been in Georgia and those other states that have adopted parity preemption provisions scuttling laws applicable to state banks that happen to be preempted for national banks? These laws could have been left in place for state banks, and an appeal might have been made to local consumers that customers of state banks had different, arguably **better,** protections than those of national banks, thus providing a competitive advantage to state banks. Rather than bucking almost two centuries of federal law curtailing the authority of the states to limit the powers of federally chartered institutions, why are the states not addressing their attention to their **own** institutions?

The answer is clear, of course: the overwhelming value for state banks and their supervisors is competitive parity, not competitive distinction, and they want to blunt any competitive advantage that national banks may have. They are willing to be "innovative" when it gives **them** competitive advantages, but not when it subjects them to burdens that they can't impose on their national bank competitors.

Yet another reason the dual banking system is under stress is because the states are under stress themselves. After a decade of budget surpluses, the states started running deficits in 2001, and further deterioration took place in 2002 and 2003. Some truly breathtaking shortfalls have been announced for the current budget cycle: California, $38 billion, with headline-making political implications; New York, $12 billion; Texas, $10 billion. One governor has called the current situation the "toughest times for states since World War II."

These developments not only make me wonder why state officials have ignored our offers to work with them to address consumer complaints and alleged abuses, but they also have serious implications for state bank supervision. In 2002, Maryland declared a moratorium on *de novo* charter applications, since lifted, because it didn't have the staff to process them — or sufficient numbers of examiners to oversee the banks that would be organized if those applications were approved. We are told that examiners in the Florida State Banking Department have seen their pay frozen for two years in a row, and that they're facing the possibility of a third. In Illinois, the governor's proposed FY 2004 budget called for a 100 percent increase in state bank assessments, and a reduction in bank examiner positions. Those modest hardships seem to have been averted for now, but it took a full-scale mobilization of state bankers to do it.

State bank supervision is also particularly vulnerable to structural changes in the industry. Over the past decade, the number of banks in the U.S. has dropped by roughly a third. With that trend has come increased asset concentration – and growing dependence on a dwindling number of assessment-paying institutions.

In fully half the states, a single bank now accounts for 25 percent or more of the asset base on which the state bank supervisor imposes the assessments needed to fund its office. In New York, one state bank accounts for nearly two-thirds of the assets under state supervision. In Georgia, one bank accounts for 70 percent of assets. In Rhode Island, it's 76 percent. Needless to say, the loss of a large bank in such a highly concentrated state could have a crippling effect on a state supervisor's ability to provide quality supervision.

These perceptions are reinforced when state supervisors actively proselytize for charters. We have a growing collection of soliciting materials used by state supervisors in recent years in their direct merchandising efforts aimed at inducing national banks to convert to state charter, and these efforts seem to get bolder by the minute. Notably absent from these materials is evidence of the vaunted "innovation" that state supervisors are so fond of extolling. Rather, the pitches are generally based on two arguments: One, we are more "accessible", and two, we are cheaper.

I suppose we all have our own ideas about just what is intended to be conveyed by the "accessibility" pitch. Whatever may be intended, however, it is likely that some will read "more accessible" to mean "more compliant," and if that is so one must ask whether such promotion is consistent with the interests of systemic safety and soundness – let alone what kinds of banks and bank managers are likely to be attracted by this pitch.

As far as state supervision being "cheaper," I'm sure you have all heard me declaim about fee disparity, and I will not go into that subject again. Suffice it to say, state supervision is cheaper because the Federal Reserve and the FDIC subsidize the cost of state bank supervision to the tune of about $1 billion a year, while national banks pay the full cost of their supervision. In the final analysis, it is this subsidy, rather than "innovative" supervision, that is the defining characteristic of the state system.

But like any subsidy there is a danger that this one can become an addiction with state banking systems becoming dependent on it.

There are those who believe that absent this subsidy, in a world in which all banks bore the full costs of their supervision, there would be little reason to maintain a state charter, and, consequently, state banks would convert to national charter in droves. I don't share this view. While we have not seen a great deal of innovation in recent years, state banking is not so moribund that it needs a federal "fix" to stay alive. I think that the overwhelming number of banks make their charter choice based on qualitative considerations other than the costs of supervision. In my view, that explains why some 1900 community banks under $1 billion in size – those banks likely to be most sensitive to such cost factors – hold on to their national charters and value OCC supervision.

But if I am wrong – if eliminating fee disparity **would** encourage a wave of conversions – then we should all be concerned about it, and we should be exploring means to breathe new vitality into the state system, rather than keeping the system on federal life support. Obliterating distinctions that are the essence of the dual banking system, however, is not the solution.

One might conclude from my remarks today that I see prospects for the dual banking system itself to be somewhat uncertain. Yet it would be profoundly premature – as well as ahistorical – to suggest that its days are numbered. The dual banking system has confounded legions of doomsayers over the years. Its resilience is legendary. I believe it's possible to restore real qualitative value to state banking. I believe it's possible to make state supervisors a more dynamic presence in the supervision of their own institutions. I believe it's possible to revive real innovation in financial services. And I believe it's possible to restore real supervisory competition – based not on cost or subtle suggestions of leniency, but on competence, professionalism, and the kind of competition that benefits consumers and promotes safety and soundness. A system that seeks to obliterate differences rather than encourage the competitive benefits that come from innovation and real distinctions between service providers; a system that trumpets the value of duality while attacking the basic distinctions that lie at the heart of duality; a system that has developed a dependency on a shot in the arm from the federal government that dulls rather than promotes competition, is a system that has unfortunately lost touch with its roots, and with the true genius of our dual banking system.