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Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the Women in Housing and Finance, on federal preemption and the relationship between the U.S. Constitution and state laws, Washington, D.C., February 12, 2002

One of the things I find so impressive about Women in Housing and Finance (WHF) is the range of interests, occupations, and backgrounds of its members—so very different from many of the industry organizations, comprising ever-narrower sub-specialties, with which we bank regulators spend so much of our time.

WHF, by contrast, has no political ax to grind or hidden agenda to advance. It brings together women—and men—who, apart from an association with the housing and financial industries, broadly defined, may be united primarily by respect for their mutual accomplishments—and by the pleasure of each other's company.

By the same token, it is a genuine pleasure to be in *your* company today.

I want to speak today about a subject that has largely been the preserve of legal scholars and banking attorneys—federal preemption, and, more specifically, the relationship between the U.S. Constitution and state laws that are intended by the states to be applicable to banks.

The OCC's role with respect to preemption was recently the subject of a lead article in the *Wall Street Journal*. The authors' thesis was that in supporting the preemption of state laws for the benefit of national banks, the OCC was reflecting an "anti-consumer" bias. Instead of going to court "to check the economic power of banking titans," as the *Journal* colorfully put it, the OCC has consistently defended national banks' claims of immunity from local laws intended to protect consumers.

Moreover, the authors argued, the OCC has aggressively supported the preemption of state laws in order to keep national banks, which, as we all know, pay two-and-one-half times more, on average, in supervisory fees than state banks, from converting to state charters.

Well, as often seems to be the case with such stories, the authors got it partly right and partly wrong.

There is no question that national banks' immunity from many state laws is a significant benefit of the national charter—a benefit that the OCC has fought hard over the years to preserve. The ability of national banks to conduct a multistate business subject to a single uniform set of federal laws, under the supervision of a single regulator, free from visitorial powers of various state authorities, is a major advantage of the national charter.

To understand *why* Congress saw fit to create national banks as instruments of federal policy with this significant immunity from state authority, it's necessary to step back briefly in time.

Banks have never been the most popular of American institutions, and in the early days of the Republic, banks that operated under a broad grant of national authority may have been most unpopular of all. It was Jefferson who spoke for many of his generation when he said that "banking institutions are more dangerous than standing armies." Given what Americans had just been through at the hands of the British Army, that was saying quite a lot.

But even Jefferson conceded that if banks were an evil, they were a necessary one. That was the dilemma we've been wrestling with ever since.

In 1791, at the urging of Alexander Hamilton, Congress created the First Bank of the United States—our first venture into the area of central banking. When the bank's 20-year charter expired, the bank expired with it. But a crumbling economy led lawmakers five years later to create the Second Bank of the United States, which proved no more popular than the first. And state-chartered banks, of which there were well over 100 by 1816, took advantage of that unpopularity by encouraging state legislatures to pass a variety of discriminatory laws, hoping to rein in, if not destroy, the sometimes overbearing Second Bank.

Maryland's contribution was an annual tax of $15,000 levied against its Baltimore branch. When the bank refused to pay, it was successfully sued in state court. In the name of its cashier, J.W. McCulloch, the Second Bank appealed that verdict to the U.S. Supreme Court.

What emerged was one of the landmark decisions in our history. Speaking for a unanimous court, Chief Justice Marshall declared constitutional Congress's creation of a national bank and declared unconstitutional Maryland's

attempt to weaken it through taxation. On the first point, Marshall elaborated the "loose constructionist" view of federal power associated with Hamilton, an expansive view based on a strong union.

On the second point, regarding Maryland's attack on the Second Bank, Marshall invoked the Supremacy Clause—paragraph 2 of Article VI—holding that the Constitution of the United States, and the laws promulgated under it, are the law of the land and carry a presumption of supremacy over the states. "The States," Marshall affirmed, "have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control the operations" of any agency created by lawful exercise of federal authority.

Of course, the states could still send elected representatives to Washington to accomplish the same end by federal legislation or presidential authority, and under President Andrew Jackson, legislation to extend the life of the Second Bank was vetoed.

With the loss of this centralizing and stabilizing influence, the U.S. banking system stumbled into near-anarchy. Indeed, one is hard pressed to call it a system at all, because standards and practices varied enormously from state to state. In states like Indiana and New York, new bank organizers were required to have real capital, and their operations were subject at least to some degree of government supervision. But in many states, banks could organize without a dollar's capital to their name, and supervision was virtually nonexistent. That permitted the shadiest of operators to enter the field—and dominate it in some states.

The currency of the country consisted of notes issued by those banks, and the practice of issuing bank notes with no or inadequate real assets backing them up became a national scandal—and a huge burden on interstate commerce, which depended on a reliable currency. To keep redemption-minded note-holders at a safe distance, bank operators became experts at evasion, moving their hole-in-the-wall offices to frontier backwaters "where only the wildcats roamed." Thus did the Wildcat Era in banking acquire its name.

Like most such characterizations, this one was unfair to the outliers—responsible bankers, in this case, of whom there were many. But the lack of uniformity in the value of currency was itself a great flaw in the nation's banking before the Civil War, because it gave rise to confusion and uncertainty—two major obstacles to economic development.

This situation cried out for a remedy, and the Civil War-era Congress supplied one that served two important objectives: first bringing uniformity to the currency; second, financing the Civil War. The Office of the Comptroller of the Currency was created to charter and supervise national banks, which would serve as the instruments of a uniform and secure national currency, and help stabilize and support the national economy.

When the Comptroller chartered a new national bank, a portion of the bank's paid-in capital was used to purchase Treasury securities, which not only filled the Union's coffers, but which was pledged as backing for circulating notes issued by the banks with the Comptroller's approval.

Operating under a broad and potent grant of enumerated powers and such "incidental powers as shall be necessary to carry on the business of banking," the national banks were designed from the outset to carry on their business under uniform rules, uniformly high standards, and uniform federal supervision. And their notes, backed by government obligations, would circulate at uniform value.

Another feature of national banking was its uniformly national character. Initially the offer of easy conversion to the national charter was expected to provide sufficient incentive for state banking to liquidate itself. But the lagging pace of voluntary conversions led Congress to adopt the Marshall dictum so nicely expressed in the *McCulloch* case—"the power to tax is the power to destroy." It imposed a "death tax" on the notes of state banks, a tax that congressional backers promised would be every bit as effective in driving out state banks as an outright ban, which was also considered.

Of course, they were wrong. State banking was able to adapt simply by substituting deposit-taking for note-issuing, and by taking advantage of state regulations deliberately tailored to permit them to engage in many activities deemed too risky for national banks.

The dual banking system was thus born—not in fulfillment of a national plan, clearly, but in spite of it. Reflecting the country's basic ambivalence about banking and the use of national power, a less confrontational Congress reconciled itself over time to a dual banking system rather than a unified one, embracing a more benign view of state banking as a legitimate expression of state sovereignty and a source of salutary competition for national banks.

With this outcome, the stage was set for future federal–state tensions. First, states sought to determine how much control, if any, they would have over the powerful new

federal financial institutions that operated within their borders. Second, as the sponsors and at least nominal supervisors of state banks, they had a material interest in ensuring that those banks remained competitive—through positive grants of powers and privileges and, if possible, through limits on the powers and privileges of their national competitors.

The courts quickly decided that there *were* limits to the immunity from state law conferred by the national bank charter. For instance, in *McClellan* v. *Chipman,* an 1896 case, the Supreme Court upheld the right of the states to regulate contracts involving a national bank. It also affirmed the state's authority to regulate the transfer of real property. In *Anderson National Bank* v. *Luckett* of 1943, it rejected a bank's claim that it was not subject to state escheat laws.

In later years, Congress, in some cases, adopted state law as the reference point for some national bank powers, as it did in the 1927 McFadden Act, setting out the branching authority of national banks.

On the other hand, in an overwhelming body of case law built up since the enactment of the National Bank Act, the courts, echoing *McCulloch* v. *Maryland*, have been emphatic about where the states may *not* go. State laws may not "stand as an obstacle" to the accomplishment of the purposes for which Congress *created* the national bank charter.

The states may not "prevent or significantly interfere with" the activities lawfully engaged in by national banks. They may not "impair" or "prevent" national banks from exercising congressionally granted powers. They may not regulate at all in areas in which the federal interest predominates or where Congress has "occupied the field" to the exclusion of the states.

Decisions of the Supreme Court have overwhelmingly endorsed the preemption doctrine as it applies to national banks—a record of consistency that transcends changes in the political or philosophical makeup of the court.

In *Davis* v. *Elmira Savings Bank*, an 1896 case, the court rejected an attempt to give preference to a state institution's claim on an insolvent national bank, while in 1954, in *Franklin National Bank* v. *New York*, the court ruled that a state could not regulate a national bank's advertising campaign.

In *Barnett* v. *Nelson*, the court in 1996 once again enjoined the states from erecting obstacles to "the accomplishment and execution of the full purposes and objectives of Congress." In that case, the court found that a Florida state law barring national banks from selling insurance in small towns was in "irreconcilable conflict" with the National Bank Act, and was thus preempted.

While the OCC has no self-executing power to preempt state law, it has, on many occasions, expressed opinions about the preemptive effect of federal law. In recent years, for example, we have opined that state laws that impose restrictions on such financial activities as ATM fees, auctions, and trust services cannot lawfully apply to national banks.

The consequences of these decisions have been to preserve and protect a national banking system operating under unified federal supervision. The rationale for such a system is as compelling today as it was in 1863.

That's certainly true for the ever-growing number of business and retail customers who benefit from access to nationwide banking services. It is doubly true for the multistate and nationwide banking organizations that serve them.

In 1863, as I've already mentioned, state supervision, with few exceptions, was nonexistent or worse. Today each of the 50 states and the District of Columbia have active supervisory schemes in place, based on impressive foundations of laws and regulations singularly theirs. In addition, the Federal Reserve and the Federal Deposit Insurance Corporation, as major players on the supervisory scene, devote thousands of examiners to the supervision of state-chartered banks.

To be sure, state supervisors have responded admirably to the needs of a multistate environment, through a master agreement allocating primary supervisory authority for state banks with interstate branches. Nonetheless, the national bank charter remains the most efficient means of conducting broad interstate banking activities.

It's important to note that, for better or worse, the preemption doctrine is value-blind and agnostic with respect to the desirability of the state law involved. In preemption situations, the only relevant issue is whether the state law would impair or significantly interfere with a national bank's exercise of powers granted to it under federal law. If such an impact is found to exist, federal law must prevail. Any opinions we might have about the desirability or merit of the laws in question are not relevant.

Let me give you a hypothetical example. I have long been convinced, going back to my days as Under Secretary

of the Treasury for Domestic Finance, that many of our concerns about the "unbanked" could be well addressed through effective use of technology. I have repeatedly urged banks to offer low-cost electronic, direct-deposit, debit card-based banking accounts to low- and moderate-income Americans, hoping to help break their dependence on check-cashers, payday lenders, and other higher-cost financial providers.

Now let's say that a state chose to pass a law *requiring* all banks to offer such electronic accounts, defining the nature of the account and imposing a fee cap. I would applaud that action by the states. I would encourage Congress to follow suit. But until it did, I would also have no choice but to hold national banks immune from such a law. Under prevailing rules of preemption, the states simply do not have the authority to order national banks to offer specific types of accounts or to regulate what they charge for services.

While some might view such a position in this hypothetical case as "anti-consumer," I would caution against such simplistic characterizations. Take the case of those local laws that have sought to bar banks from imposing charges for the use of ATMs by persons who do not maintain an account with them—the so-called ATM surcharge laws. Such laws have an undoubted political appeal—given a choice, most people would naturally prefer not to pay a charge for using an ATM, regardless of who owns it.

But a major incentive for banks to deploy ATMs is the expectation of profit from the use of their terminals by noncustomers. Thus, terminal deployers seek out new locations for their ATMs in the hope that many people will find it convenient to use their terminals—either paying a fee for the privilege or becoming a customer to enjoy free use of the ATM.

Noncustomers clearly benefit from the increased deployment of ATMs by banks seeking fees, and would clearly be less well off if anti-surcharge laws diminished the incentives of such banks to seek out new users.

Not only are such laws preempted by federal law, as the courts have consistently held, but they are fundamentally wrong-headed, pretending to help consumers when in fact they do quite the opposite. There is no clearer evidence of this than the dramatic increase in ATM deployment that occurred after the ATM networks abandoned their own rules barring such surcharges.

Let me raise one other caution about preemption. The benefit that national banks enjoy by reason of this important constitutional doctrine cannot be treated as a piece of disposable property that a bank may rent out to a third party that is not a national bank. Preemption is not like excess space in a bank-owned office building. It is an inalienable right of the bank itself.

We have recently seen several instances in which nonbank lenders who would otherwise have been fully subject to various state regulatory laws have sought to rent out the preemption privileges of a national bank to evade such laws. Indeed, the payday lending industry has expressly promoted such a "national bank strategy" as a way of evading state and local laws. Typically, these arrangements are originated by the payday lender, which attempts to clothe itself with the status of an "agent" of the national bank. Yet the predominant economic interest in the typical arrangement belongs to the payday lender, not the bank.

Not only do these arrangements constitute an abuse of the national charter, but they are highly conducive to the creation of safety and soundness problems at the bank, which may not have the capacity to manage effectively a multistate loan origination operation that is in reality the business of the payday lender. As you probably saw, we recently took supervisory action against a small national bank that dramatically demonstrated its inability to manage such a relationship in a safe and sound manner.

Finally, let me say a few more words about the role that the OCC plays in consumer protection. Even if one were to view all state enactments in this area as "pro-consumer," and all OCC support for preemption as "anti-consumer," that simplistic view of life ignores the fact that the overwhelming volume of consumer protections for bank customers have come from federal laws that are clearly applicable to national banks. We conscientiously enforce all of those laws. In fact, we have more than 300 examiners who spend all or part of their time on consumer protection compliance.

And I think we have played a real leadership role in this regard. Not long ago, we required one large credit card bank to make restitution payments of at least $300 million for overreaching against consumers. We have asserted the authority to use our cease-and-desist powers to remedy unfair and deceptive practices that violate the Federal Trade Commission Act, and that authority has been recognized in court. And, as I have already mentioned, we recently forced a national bank to take steps to exit the payday lending business. We take tremendous pride in delivering a high level of protection to consumers without subjecting national banks to excessive—and costly—regulatory burden.

One can hardly think of two subjects that have aroused more intense feeling in our history than banking and the relationship between the federal government and the states. It is a matter of historical fact that emotions ran almost as high in the war against the two Banks of the United States—and war is the metaphor that was almost always used in describing those events—as they did in the all too literal war Americans fought against each other some years later. It seems fitting that the national banking system was one of the byproducts of that conflict.

These two epic issues—banking and federalism—converge in the preemption question. In that sense, it's not surprising that preemption—on one level, an abstruse legal concept—is still capable of generating passionate controversy. But we cannot allow our emotions to rule when it comes to public policy. Balance, sober judgment, and perspective are all crucial. And for that we rely not only on those who govern, but also on an informed, responsible—and historically literate—citizenry.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the Institute of International Bankers, on the status of the new Basel Capital Accord, Washington, D.C., March 4, 2002

The New Basel Capital Accord: A Status Report

It's been an extraordinary year since I last spoke to the Institute in this forum—a year that saw both unspeakable tragedy and awe-inspiring heroism. And it saw something else that I think few people expected in the wake of September 11—extraordinary solidarity in the international community. To date, no fewer than 147 nations have frozen assets linked to terrorist organizations. International cooperation in the anti-money-laundering campaign has been exemplary. Dozens of nations are cooperating in the effort to root out terrorist cells. Others have contributed combat and logistical support to the war in Afghanistan and are now contributing significantly to the international effort to rebuild that country's shattered infrastructure.

I believe this experience may have some relevance for those of us who are engaged in the effort to bring about greater harmonization in the supervision of internationally active financial organizations, in particular for the Basel Committee on Banking Supervision. The year 2001 began auspiciously with the release of the second consultative draft of the committee's proposal for a new capital accord—a 500-plus-page set of documents. The committee also announced an ambitious schedule for moving ahead with that proposal: a four-month comment period, final publication of a new accord by year-end 2001, and full implementation in 2004.

As spelled out in the consultative package, the new framework for regulatory capital—which I shall refer to as "Basel II"—aimed to address many of the distortions that have resulted from Basel I, the original 1988 capital accord. Although it represented a breakthrough in many ways, the 1988 accord was found to be seriously deficient in others, and these deficiencies have become more conspicuous with each passing year. It is now widely acknowledged that Basel I inadequately differentiates among institutions of varying risks and risk management capabilities. In some respects, the Basel rules have even proved counterproductive, having encouraged some institutions to move high-quality assets off the balance sheet, thus reducing the average quality of bank loan portfolios.

Despite the good that has come from it—and the good has been substantial—there's now a general and understandable sense that time has overtaken the 1988 accord.

The proposal for a new accord that was rolled out last January is designed to provide a framework that's as sophisticated as the industry itself is today—and yet one that also accommodates the industry's extraordinary diversity, both among and within its home countries.

Before it commenced work in earnest on the proposed new accord, the Basel Committee laid out five objectives to guide its efforts.

- First, any new capital rule should at least maintain the current overall level of capital in the banking system.
- Second, it should promote competitive equality and a level playing field for international banks.
- Third, it should take a comprehensive approach to addressing risks.
- Fourth, its approach to capital adequacy should be appropriately sensitive to the degree of risk inherent in a bank's positions and activities.
- And, finally, a new capital rule should focus on internationally active banks, although its underlying principles should be suitable for application to banks of varying levels of complexity and sophistication.

Those were the guidelines that the committee set for its own work. I would add the following as important principles that should also guide the committee:

- First, I strongly believe that whatever rule we adopt must work in practice as well as in theory. A rule that is intellectually elegant but overly complex and difficult to comprehend and implement may create more problems than it solves.
- Second, the rule has to provide supervisors with sufficient flexibility to accommodate differences among financial institutions. Institutions should not be forced to modify practices that raise no safety and soundness

concerns, and settled, well-functioning markets should not be disrupted, simply in the name of compelling adherence to a common rule.

- Finally, I believe it's exceedingly important from a domestic perspective that we avoid impairing the competitive vitality of U.S. banks, and, from an international perspective, that we avoid placing banks generally at a competitive disadvantage compared to other financial service providers. To be sure, banks play a special role in the economy of every country and thus frequently warrant special treatment. But the line between banking and other financial services is becoming increasingly blurred, and we must recognize that investment banks, insurance companies, and other nonbank institutions are major competitors of banks.

So—how well did we do? Did the document released in January of last year meet these standards, or did it fall short? If the latter, what steps should we now take to correct any deficiencies and to produce an accord that will genuinely contribute to a safer and more competitive global financial system?

To answer those questions, a more detailed review of Basel II—and of the reaction to it from its various constituencies—is in order.

The new accord, as I'm sure you know, is built on three pillars: minimum capital, supervisory review, and market discipline. It would reward banks that have developed the most advanced internal risk-rating systems by allowing them to use those systems in the calculation of their capital requirements—the so-called "internal risk ratings-based approach," or IRB. Banks with less developed capabilities would have a somewhat less advantageous methodology, while banks with more rudimentary risk management systems would utilize risk weights and capital charges established by the committee under a standardized approach.

But even banks adopting the IRB approach would not be unconstrained in calculating their own capital requirements. The primary regulator would still be responsible for evaluating and validating each institution's models and risk-rating system and for assuring that they are applied with consistency and integrity. Banks' internal processes would be subject to regular supervisory testing—and intervention, if necessary. And all internationally active banks, regardless of their complexity, would be required to make a capital allocation for operational risk.

Moreover, the Basel Committee envisions an important role for the financial markets as a barometer of the financial condition and risk profile of regulated institutions—as well as a reality check on the job we do as regulators. Thus, the third pillar of Basel II would require that financial institutions improve the quality and quantity of the information they make public, so that financial markets have the ability to make accurate and informed judgments on the health of each institution.

The transparency pillar has an important additional function that should not be overlooked. It will provide both banks and supervisors with information that will enable them to assess how the requirements of the accord are being observed and applied in other countries. In this respect, it will facilitate a kind of "self-policing" of compliance by banks subject to the accord and their supervisors.

A brief summary obviously cannot do justice to a dense document of 500 pages, but there you have the highlights, at least, of Basel II—the product of months of consultation among the principals and extraordinary effort by the committee secretariat and the staffs of the various committee members. That we have been able to come as far as we have is a tribute to the strong and skillful leadership of Bill McDonough, who brought to bear not only his standing as one of the world's leading central bankers, but his extensive practical background as a banker. By not underestimating the difficulties that stood in its way, Bill has kept the highly collegial but occasionally fractious committee on point and headed in the right direction. Indeed, it is not taking anything away from the great service our members have rendered to say that our proceedings have been marked by spirited exchanges of viewpoints that reflect the wide differences in legal, supervisory, and accounting practice in our respective nations. The committee's proceedings underscored the importance of developing rules that make sense, at least in terms of their broad principles, not only for the G-10, but also for all nations expecting to operate under the Basel framework.

We expected that the reaction to the proposed accord issued in January 2001 would reflect the wide divergence in financial practice around the world, and in this regard we were not disappointed. Some stakeholders urged us to simplify; others asked that it be made even more risk-sensitive—and, at the same time, more complex. Smaller, noncomplex institutions in the United States went on the record as expressing a preference for the status quo; the gains promised under the new accord, they said, seemed not worth the trouble and expense of shifting to a new system. Many institutions particularly objected to the capital charge for operational risk, disagreeing both with

the definition of operational risk *and* with the amount of capital they would be expected to set aside for that purpose. Even the risk rating agencies, which might have been expected to applaud a system that would utilize their services for banks without reliable in-house risk-rating capabilities, worried publicly about conflicts of interest and the possibility that they would be perceived as unduly influenced by the regulators.

The committee's initial cut at Pillar 3 raised very substantial objections, and knowledgeable observers were quick to point out that market discipline, as contemplated in Basel II, can be an elusive concept—difficult to standardize and potentially burdensome in terms of the disclosures the industry would be required to produce. Indeed, just days before last January's release, a Federal Reserve-sponsored working group issued a report that cast doubt on the value of disclosures for regulators given the different risk management methodologies in use among financial institutions. And a day after the release of *that* report, the Treasury Department and the Federal Reserve released a joint study concluding that what some industry analysts had viewed as among the most promising tools for market discipline—the use of subordinated debt—was actually of questionable value.

What we had at the end of the day, then, was strong support for the Basel principles and equally strong opposition to many of the details of the proposed Basel II rules. To the committee's credit, it has devoted a tremendous amount of time and energy in an effort to meet these and other concerns and to continuing the dialogue with the industry. It has already revised downward the proposed charge for operational risk from 20 percent of total regulatory capital to 12 percent in the standardized method, and it has laid the groundwork for a nonformulaic approach to operational risk in the other method—the Advanced Measurement Approach, or AMA—that would look more to a bank's internal assessments, much as the IRB-based approach does with credit risk—although the attractiveness of this approach may be appreciably lessened by the prospect that a "floor" might be imposed. It has also cut back significantly on the volume of disclosure that would be required under Pillar 3. And in the area of retail credit, the committee has issued a working paper on the capital treatment of expected losses and future margin income that is still open for comment.

Throughout this difficult process, the committee has rightly maintained that it would do whatever it took to get the new accord right. Thus, when it became clear that it would be impossible to fairly evaluate the concerns of market participants and still meet our own implementation deadlines, we extended the deadlines. There will now be a third consultative package, although that document will not be released until committee staff has completed an additional review aimed at assessing the overall quantitative impact of a new accord on banks and the banking system. In this "quality assurance" phase, the Basel Committee will focus especially on the highly controversial question of appropriate capital treatment of credits to SMEs, the small- and medium-sized enterprises that are so vital to economic growth and job creation.

The committee is also finalizing calibration of the minimum capital requirement in order to achieve a level of capital that, on average, is approximately equal to the amount of capital produced by the present accord, while still providing incentives to banks to use internal ratings systems.

Merely stating these objectives helps to convey the difficulty of the committee's challenges. How do you satisfy the political imperative of avoiding a reduction in the overall capital of the banking system, while at the same time holding out to the largest and most sophisticated banks that a set of rules better tuned to risk may enable them to enjoy *lower* capital—unless, of course, the new rules will result in an *increase* in the capital of other more risky banks?

In this connection, a comment may be appropriate as to just which banks will be subject to the new accord. The intent is that it will be applied to "internationally active" banks. U.S. regulators have made clear that they do not intend to apply the new accord to the many thousands of community banks that serve local markets in this country.

At the same time, many of us have real questions about how many of our larger banks will be in a position to adopt the IRB approach. I think it is a fair guess that only a very small handful of our largest, most sophisticated banks—perhaps no more than 6 or 8—will qualify, at least initially, for the advanced IRB approach, and even the foundation IRB approach may not be suitable for many large banks.

There are, of course, a number of thorny issues that remain to be worked out. I have been quite concerned, for example, about the approach to operational risk, and have voiced those concerns consistently in committee meetings. I view operational risk as the risk that inheres in the quality of a bank's internal controls. Thus, two banks engaged in an identical line of business may present vastly different quantities of operational risk when the internal

control systems of one are significantly better than those of the other. A one-size-fits-all approach to operational risk—such as a formulaic capital charge based on some percentage of gross revenues or a percentage of the charge for credit risk—while simple to apply, would disadvantage the best-managed banks and provide undeserved advantage to the worst managed. Worst of all, it would provide no incentive to improve internal control systems. For this reason I have repeatedly argued that operational risk is particularly well suited for a Pillar 2 approach. But there are many on the committee who are very cautious about such a use of Pillar 2, believing it would be used for supervisors to provide competitive advantages to their banks. Those holding this view find strong comfort in highly detailed prescriptive rules. While I find the AMA concept quite appealing, I am concerned that it not be so constricted as to diminish its attractiveness to banks.

I have also been concerned about the approach to securitizations. U.S. bank regulators are keenly aware—increasingly so—of the various risks involved in securitization, and we have seen numerous instances in recent times in which badly managed securitizations have caused serious problems for banks. On the other hand, securitization has been an important risk-management and funding technique for many of our best-managed banks, which have developed securitization markets to a high level of efficiency.

While we must address the real risks here, we need to do so with care, so that we don't needlessly or unintentionally disrupt an important market. We must also avoid a "beggar-thy-neighbor" approach. The volume of securitization activity among U.S. banks vastly exceeds that of all of the other G-10 countries combined. While the popularity of securitization is certainly spreading, we must resist the temptation to embrace new rules uncritically when their burden will fall most heavily on countries other than our own.

Finally, I am concerned about the enormous complexity of the proposal. With great respect for the various task forces and working groups that have conscientiously produced extremely thoughtful papers, I would be amazed if every member of the committee has been able to plow through the details of every paper. I'm frank to say that I have not. I suppose it's a character flaw of mine that as soon as I see the symbol for an indefinite integral on a page, my attention starts to flag. Unfortunately, there are many pages of complex formulas in the committee's recent work.

I believe it is essential for a number of reasons that we make a very strong effort to simplify the articulation of the basic rules. Bankers, examiners, legislators, and policy makers need to be able to comprehend the structure and content of the new accord without having to plow through reams of mathematical minutiae. We need a reasonably concise set of black-letter rules that lay out the structure of a new accord, with such elaborating detail as is absolutely necessary left to annexes. And we should not attempt to draft language addressing every possible contingency or detail that might arise, to chase every rabbit down every hole. Again, I believe we should put more reliance on Pillar 2 to fill in the interstices. We in the U.S. have to keep in mind that before the new accord can become effective for our banks, we will have to go through a formal rulemaking proceeding, and while an agency head probably can't be sent to jail for violating the "plain language" requirement we are supposed to observe, we should at least make a stab of it.

The committee has demonstrated that it is not unresponsive to the views and interests of the industry, and I believe that banks that have provided input to the process have contributed immeasurably to our joint effort. I have urged all of our large banks to analyze the Basel proposals and to let us and the committee know their views, and I have personally met with a number of the more engaged banks to discuss the issues. The dialogue in which we have been engaged together—as supervisors and bankers—offers an excellent case study in cooperation, which bodes well for our ability to develop the inevitably complex rules that are so necessary to help us address increasingly complex risks in the global banking system.

But I also believe that we must continuously ask ourselves what "getting it right" really means. While competitive equity and uniformity of application are important objectives of the committee, we need to consider the difficulty of delivering a comprehensive framework that encompasses all the different ways that institutions are operated and supervised across the G-10 and around the world. In the U.S., for example, we have a highly developed system of bank supervision. The OCC has full-time teams of resident examiners on site at our largest banks. In other countries, the task of supervisory oversight may be quite different, with an important role being left to the outside auditors. Given such disparities, what can we expect in the way of uniform application of highly complex and prescriptive rules? Would we be less well served if the Basel process aimed instead at seeking agreement on broad principles and modes of behavior? Should we consider emulating the less prescriptive approach adopted by today's international coalition against terrorism—or by the International Accounting

Standards Board, which promulgates global standards and principles, and leaves implementation and enforcement to national authorities?

More than anything else, the committee needs to work with and understand the dynamics and operational incentives of the banking industry. We need to make certain that the new capital framework reflects and reinforces the best contemporary practice. We must be very careful to avoid micromanaging the institutions that we supervise. And above all we must be cautious not to disrupt or destroy settled markets by adopting new approaches that could have serious unintended consequences.

In light of everything that has occurred over the past year, I believe it is impossible to predict exactly what the Basel Committee's final product will look like—or when we will come to closure. Although we recognize that there are costs associated with further delay, a process that involves such complexity and such a potential for causing unintended consequences should not be rushed. We need to take the required time not only to complete the testing and calibration of the IRB approach, but also to assure that our approach to such issues as operational risk makes good sense.

Over its distinguished history, the Basel Committee has functioned best when it has focused on developing and articulating basic principles. The "Core Principles for Effective Banking Supervision," which the committee adopted in 1997, have made a tremendous contribution to the improvement of supervisory practice worldwide. Basel has been an invaluable forum for supervisors to use for sharing experiences and insights and learning from them. We have done less well when we have tried to make our vastly diverse and complex global banking system—and the variety of our supervisory arrangements—conform to a single model.

The Basel Committee is unalterably committed to the goals of financial stability and effective international bank supervision. But as we continue to learn, it is both necessary and possible to come up with mutually agreeable standards of international conduct without dictating how those standards are to be achieved or enforced. In the world of international politics, sovereign differences can be a source of strength. I believe that's just as true for international bank supervision. As the Basel Committee continues its important work, we must respect those differences—and build on them—in order to achieve a truly prosperous global economy.

Remarks by John D. Hawke Jr., Comptroller of the Currency, before the New York Bankers Association, on the condition of the banking system, New York, March 7, 2002

Judging by the most recent economic indicators—unemployment claims, productivity, consumer confidence, and the like—we may well be in the process of emerging from the nation's yearlong slowdown. But there's also the possibility that today's encouraging numbers may prove to be transient or misleading, and that the economy may be stuck in low gear for some time to come. We just don't know.

In this regard, we should respect the wisdom of the Greek philosopher Plato, who defended the act of prophecy as a moral imperative that allows us—symbolically, at least—to assert control over our fate.

At the same time, Plato conceded that trying to predict the future was a losing proposition.

That hasn't changed. A few weeks ago, federal enforcement authorities brought fraud charges against a well-known infomercial psychic, putting her out of business. One wonders why she didn't see it coming.

Today, bank supervisors have dazzling analytical tools that can be of great value in predicting how the institutions we supervise are likely to fare in the future. The Office of the Comptroller of the Currency's (OCC's) Project Canary, for example, developed an early warning system that helps us identify banks that have the greatest likelihood of developing problems. Of course, we can't be certain about the future any more than Plato could. Circumstances change, and behavioral responses that may radically affect results can't easily be modeled. We are fortunate if our predictive tools do no more than point us in the right direction. But while the future will always be with us, our primary job is to focus on the here and now—to understand the current condition of the banking system and the ability of our banks to cope successfully with the variety of contingencies that may present themselves. And that's what I'd like to talk to you about today.

Last June, I testified before the Senate Banking Committee on the condition of—and the outlook for—the banking system. I told the panel that while there were some negative trends in the industry, banks were far better prepared to deal with a slowing economy than they were at a comparable stage of the last economic downturn, in the late 1980s and early 1990s—a period that we consistently use as a frame of reference not only for assessing the health of the system, but for shaping appropriate supervisory responses as well. I pointed out that with the economic slowdown, the lowered loan underwriting standards that the OCC had been warning about for more than four years were having the effects one might have foreseen, and that problem loans, on both the wholesale and retail sides, were on the upswing as a result. I said that we had concerns about the levels of consumer and corporate leverage, and about signs of trouble in such areas as commercial real estate and subprime consumer loans.

But, I also told the panel that the industry's fundamentals were still strong. Despite the build-up in loan loss reserves, banks were still reporting strong earnings, aided by the favorable interest rate environment and robust noninterest income. Even with the rise in troubled loans, overall asset quality remained high, reflecting the industry's progress in minimizing portfolio concentrations and its embrace of advanced risk management techniques. Perhaps most important of all, capital was strong—50 percent higher, system-wide, than it was in the first quarter of 1990. On the whole, I said, the picture offered no great cause for concern—and reasonable cause for optimism about the industry's ability to achieve a soft landing after nearly a decade in the clouds.

Now, nine months later, it is a good time to examine the changes that have taken place in the economy and the banking system since my Senate testimony. Obviously we have passed through an extraordinarily eventful period—nowhere more eventful than in New York City.

September 11 was a watershed for the economy. It will be a while longer before the fourth quarter 2001 statistics on bank lending are available, but the third-quarter numbers, covering the period through September 30, reflect a key indicator of a slowing economy: a significant drop in loan activity. Overall, the third-quarter decline amounted to just under 1 percent, with the largest decline, 2.2 percent, occurring in commercial and industrial loans. Consumer lending declined at a slower rate, a little over 1 percent. Only commercial real estate defied this trend, growing by 3.6 percent.

When we break out these numbers geographically, the effects of 9/11 are even more dramatic. Predictably, the

northeast was hardest hit of all, lagging behind every other region of the country in nearly every loan category. In consumer loans, for example, negative growth in the Northeast—and among national banks in our large bank program—more than offset small gains in every other part of the country.

Beginning in late September, there was a marked upsurge in consumer borrowing nationwide. However, sharp gains proved short lived, because they were largely the result of cut-rate financing deals offered by the automakers. Once those offers ended, consumers pulled back, taking advantage of low mortgage rates to cash out some of the equity in their homes, which they used to retire higher-cost credit card debt. This was reflected in a December drop in consumer borrowing—the biggest one-month drop on record. Yet American consumers were no less leveraged—and thus no better situated to meet their debt obligations—than they were months earlier.

The year 2001 thus came to an end amid what seemed a steady stream of bad economic news. Americans were confronted by a convergence of negatives: bleak corporate earnings reports, successive rounds of layoffs, the threat of new terrorist attacks, financial turmoil overseas in places such as Argentina, and high-profile bankruptcies that dominated the business news in the weeks following September 11.

The highest profile bankruptcy, that of the Enron Corporation, not only involved losses to its lenders, but it also had a chilling effect on investor psychology, which has adversely affected all publicly traded corporations. Perhaps more significant, it has had a galvanizing effect on public policy makers. So, today we are seeing an acute case of "Enronitis"—nagging doubts about the transparency and fundamental trustworthiness of corporate financial statements, accompanied by severe criticism of corporate governance and deep-seated concerns about the security of private-sector pension plans.

Meanwhile, deterioration of loans already on the books has continued and, in some cases, accelerated. This was especially true of credits to industries that felt the effects of 9/11 most acutely: travel and tourism, insurance, retailing, media and entertainment, and their suppliers. Large-scale layoffs in these industries led to rising defaults; consumer bankruptcy filings shot up by 19 percent in 2001.

Troubled times for the economy always mean challenges for the banking system, and even if the economy has turned the corner, as some indicators suggest, we may still be six to nine months away from the point at which we can expect problem loans to peak. That means more additions to loan loss reserves, with the attendant impact on earnings for the affected banks.

We also have to keep in mind that the most serious credit quality problems so far have been largely confined to large banks or to banks that specialize in lending to high-risk borrowers. That is likely to change, however. Historically, credit quality problems tend to trickle downward, gradually spreading to mid-size and community banks. We can now see that process beginning. So, while things may not get much worse for banks that are suffering already, the ranks of the sufferers are likely to swell.

Yet, what is striking is how little has actually changed for the banking system since September 11. For all of the turmoil of these last months, evidence shows that the banking system is not in appreciably worse shape than it was when I testified before Congress last June—and still is in far, far better shape than it was at a comparable stage of the last business cycle.

In June, the return on assets for all commercial banks was 1.21 percent, more than twice what it was in 1989. As of September 30—the most recent date for which numbers are available—it was 1.17 percent.

In June, nonperforming assets for all commercial banks stood at 0.82 percent of total assets, compared to more than 2.25 percent in 1989. As of September 30, it was 0.85 percent.

In June, the ratio of bank equity to assets equaled 8.76 percent, compared to 6.21 percent in 1989. Today, it stands at 8.93 percent—even higher than it was in June.

In light of all that the economy has been through, I think you'll agree that these numbers are remarkable.

The statistics say a great deal about the resilience and underlying health of the banking system. They also suggest that we are unlikely to see a repeat of the early 1990s, when the banking system's troubles complicated and prolonged the process of economic recovery. Back then, bank supervisors were accused—wrongfully, I believe—of creating a "credit crunch" by taking too tough a hand with their banks. Whatever the merits of that charge, I am committed to assuring that our supervision of national banks doesn't get in the way of economic recovery. This does not, by any means, mean encouraging bad loans, or closing our eyes to them. It does not mean that we should break out in a sweat every time some

entrepreneur who is turned down for a loan sees a "credit crunch" in the offing, like Henny Penny fearing that the sky is falling. Our job is neither to encourage nor dissuade banks from making loans. Our job is to address problems as we see them arise, and to do so in a measured and forthright way. Our job is to do what we can to assure that when creditworthy loans are there to be made, our banks are in sufficiently good condition to make those loans. If we are successful in doing this, we will have made the best contribution we can to a healthy economy. One need only look at Japan to see how a failure to attend to the fundamental health of the banking system can have a devastating effect on economic recovery.

The significance of the recent past is often as difficult to fathom as the future. But there's evidence that the economic pain of recent months may point the way to a more robust and sustainable recovery. For example, the Enron affair may lead to beneficial reforms of some corporate practices. As I have been saying for many years, when corporate managers place undue emphasis on short-term performance and the approval of the analyst community of their quarterly results, they do a disservice to their customers, employees, and shareholders. In the current climate, bankers who move to restore the proper emphasis on fundamentals and long-term shareholder value may find greater support for their efforts than has been the case for a long time.

We are likely to see other companies take steps to better align their accounting practices with the economic substance of their activities, strengthen their internal controls, and improve the quality of the oversight provided by boards of directors. When all is said and done, we could well have a more transparent, more efficient, and more fundamentally sound financial marketplace—a marketplace that will lend strength to the gathering recovery.

We also see compelling evidence that banks are not only strengthening their risk management and loan workout capabilities to deal with credits already on the books, but are exercising a higher level of prudence and responsibility in underwriting new loans.

Recently, the Federal Reserve's survey of senior loan officers showed, in general, continued tightening of credit standards by U.S. banks, with tightening most pronounced in commercial and industrial and commercial real estate loans. But the same survey provided evidence that banks are still willing and able to lend to creditworthy customers. Given the level of liquidity in the banking system, this is not surprising. The percentage of domestic banks that reported having tightened loan terms to large- and middle-market firms actually declined from previous surveys, with particularly striking declines in the percentage of banks that increased loan spreads to these borrowers. On the other hand, an increasing percentage of banks did raise premiums on the riskiest loans, suggesting better assessments of the risk-adjusted returns for these products.

Such policies may indeed help bankers avoid the problems of the future. But it is not too late to deal effectively with many of the problems that bankers face *today*. Most bankers are approaching these problems from a position of strength. That gives you options—and opportunities to take control of your fate. It has never been more important than it is today to keep your eyes on the future rather than the end of the next quarter.

This means:

- Building and maintaining strong credit analysis, portfolio monitoring, and loan review capabilities.

- Recognizing and dealing with deteriorating credits forthrightly, rather than trying to pretend that no deterioration has occurred, or that it will correct itself if left alone.

- Building and maintaining sound workout and collection operations capable of dealing effectively with troubled borrowers.

- Building and maintaining a strong capital base and conservative loan loss reserves, even at a time when profits are being squeezed.

- Continuing to invest in enterprise-wide risk management and portfolio MIS. As an added benefit, bankers who upgrade their internal risk ratings capabilities will be one step ahead of the proposed Basel accord, which is likely to encourage and reward bankers to adopt more robust and accurate credit risk management processes.

Many banks *are* doing these things. Risk recognition and rating accuracy *have* clearly improved since the last time the industry faced comparable challenges. And, many bankers came out of the last recession as true believers in the need for a strong capital base. One leading banker, whose institution had been under severe capital pressure in the 1980s, said at an OCC conference two years ago that never again would he let capital fall even to the level the regulators defined as the minimum needed to be

considered "well-capitalized." It's in large part *because* the industry and its regulators have put such strong emphasis on capital that banks are holding up so strongly. Clearly, we have all learned from experience.

And, let me say finally that bank regulators in particular have learned lessons. In the recession of a decade ago, we were criticized for adopting policies that appeared erratic and inconsistent. In some cases, we swung from forbearance to harsh supervisory action against banks whose condition had deteriorated—but too late to avert many failures. We have learned from these experiences—and are determined never to repeat them.

We have learned that ignoring or failing to comment on increasing risk or deteriorating conditions is poor supervision. We serve our banks best—and best serve the public—when we forthrightly convey our concerns to bank managers and encourage them to address changing circumstances. For example, two years ago we became very concerned about the volume of "enterprise value" lending we were seeing—that is, credits whose repayment depended on the borrower's success in realizing projected cash flows, frequently from start-up ventures. We viewed this as no more than a very chancy kind of unsecured lending—or, perhaps more accurately, as a kind of equity investment, without any upside. We knew we were on to something when we heard loan officers refer to these credits as "airball" loans. We heard some carping about our repeated comments on this subject, but I believe our focus on this practice served banks well. Just recently, one of the country's leading bankers said to me, somewhat apologetically, "You guys were absolutely right about that enterprise value stuff."

September 11 cost us much. But it also taught us much—about our strengths and our vulnerabilities, about our friends and our enemies. It taught people around the country and around the world things they never knew about the character of the American people—and especially the character of New Yorkers. Its suddenness reminded us of what Plato tried to teach us two thousand years ago—that try as we might to divine the future, it is—and always will be—essentially unknowable.

We cannot predict the future. But we can certainly influence it with the work we do. And no group has greater power to influence the general prosperity—and its own present and future well-being—more than the banking community. On behalf of the OCC, I would like to congratulate the New York Bankers Association for the fine work that you have done through these enormously challenging times to uphold the promise of better times ahead—for all Americans.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the American Bankers Association National Community and Economic Development Conference, on competition and growth in the banking industry, Baltimore, Maryland, March 18, 2002

Banking is one of our nation's most mature industries—mature in the sense that economists use the term—and as I increasingly use it, as a euphemism for advancing age. Indeed, banking grew in lockstep with America, beginning by serving the modest financial needs of a nation of small towns and subsistence farmers, then fueling the rise of the mighty industrial and technological economy we know today.

Banking is also mature in the sense of its penetration of the present-day market for a distinctive array of financial services. The reach of the banking system—in the form of bank-originated home mortgages, small business loans, credit cards, and deposit accounts—is greater today than ever before. Three-quarters of all adults now own at least one credit card; 96 percent of all U.S. households with income over $25,000 annually hold bank deposit accounts. Obviously, today's consumers have a wide range of options among financial providers, and banks must contend with a more crowded marketplace for products and services it once dominated. But gloomy predictions that we would find that the industry's best days were behind it have proved wrong, and the banking franchise today is as strong as ever.

This record is a source of justified pride to the industry. But it also raises the question that industry leaders have been grappling with for years: where do we go from here? Despite the industry's rapid consolidation over the past decade, meaningful gains in the market for traditional bank products have proved highly elusive—and expensive to achieve. Each year, for example, credit card issuers churn out new billions of direct mail solicitations to potential customers, and get proportionately fewer and fewer responses in return—0.6 percent in 2001, down 50 percent in only three years. And bankers have come to recognize that the customers gained in this low-yield manner are likely to stay customers only until a competitor comes along with a better deal. In the zero-sum game that financial services competition has become, every gain to one provider represents a subtraction to another.

So where should banks turn to achieve the growth—and the profits—they feel they must have to attract capital and stay vigorous? Some institutions are taking advantage of recent changes in laws and regulations that now permit them to compete in markets for such products as insurance, securities, and investment services. But while the potential for growth in these areas is no doubt substantial, it's also clear that banks wading into these jungles will find them thick with competitors who have been there longer, know the territory better, and are unlikely to yield their dominance without a fight. Gains in these markets, too, are not likely to come easy—which may be why banks have edged so cautiously into those areas.

So it seems logical for banks to aggressively pursue opportunities to *expand* the market for traditional bank products, by fashioning those products in new and more responsive ways to a broader range of customer needs—in short, by bringing new customers into the mainstream of the banking system. Where those opportunities exist—and how to capitalize on them—are among the questions that have brought us to Baltimore.

The conference program suggests the range of market-building opportunities that are there for the taking. Let me mention three areas that seem to hold particular promise. The first is small business lending. Although the number of minority-owned businesses has increased dramatically in recent years, the use of bank credit by those businesses has lagged well behind that of their peers. According to a recent *Survey of Small Business Finances*, only two-thirds of minority-owned businesses used credit, compared to over three-fourths of all businesses. For African-American-owned businesses, the numbers are even lower. Clearly, there's a subset of the small-business market that banks have only begun to serve.

That's also true in the area of homeownership. Although the U.S. homeownership rate is now nearly 68 percent—an all-time record—the rates for African-Americans and Hispanics remain below 50 percent. The gap between these rates represents approximately $600 billion in potential home mortgages—a sizable market opportunity for banks.

Last but not least, there are important opportunities to build mutually profitable relationships with millions of ordinary Americans who do not conduct all of their routine banking transactions *with* banks. I'll use the term

“underbanked” to encompass two groups. First, there is the nearly 10 percent of American households that still do not have a deposit account at a financial institution and rely heavily on nonbank financial service providers for their basic banking needs. People without formal account relationships may still occasionally use banks as a secondary source of financial services—for example, when they cash a third-party check at the bank of issue. But nonbank financial outlets are where the majority of their financial services are obtained.

I’m also using the term “underbanked” to refer to what is customarily characterized as an entirely separate population: individuals who rely to a greater or lesser extent on high-cost, short-term credit provided by nonbank lenders, often in the form of “payday” or “cash advance” loans.

On first glance, the argument that these are two markets rather than one seems compelling. By definition, people without bank accounts cannot also be payday loan customers—at least as the payday loan business is now generally conducted—for such loans, secured by postdated checks, obviously require customers to have active checking accounts in good standing. That makes for some demographic differences, too. Payday loan customers, like the majority of Americans with banking relationships, out-earn people without bank accounts—although the household income of payday borrowers places them somewhere between the average non-account holder and the average bank customer.

Yet analysis reveals important similarities between those Americans without bank accounts and the typical payday loan customer—similarities suggesting that much of what we know about one population may be applicable to both. First, the two populations may patronize identical nonbank financial outlets, some of which, as I’ve noted, provide a well-stocked menu of financial services. Second, both populations—irrespective of household income—are likely to contain large numbers of people living near the edge economically, with few financial resources to fall back upon.

But perhaps the most salient similarity is that both populations have turned away from banks—or have been turned away *by* banks—in obtaining at least some of the financial services they regularly need. And that, I believe, may help to explain *why* they are living near the edge. Some may be paying more for financial services than they need to; others are missing out on opportunities to build financial assets and relationships so crucial to long-term financial independence.

What’s more, the two groups are underbanked for many of the same reasons—reasons I’ll discuss momentarily.

This situation poses a challenge for banks—and an opportunity. The challenge is to understand why people who might become bank customers aren’t doing so. The opportunity is to change their minds and their financial habits. It’s a high-stakes undertaking—for banks, for current and potential bank customers, and for our economy.

On one point—the magnitude of the potential market for banks—there is little controversy. The nonbank financial industry is huge—and growing.

For example, in 2000, Americans cashed 180 million checks at 11,000 check-cashing outlets, generating fees of $1.5 billion.

No segment of the nonbank financial industry has grown more rapidly than payday lending. Ten years ago, the payday loan industry hardly existed. Today, up to 10,000 outlets nationwide provide payday loans totaling between $8 and $14 billion, generating fees totaling up to $2.2 billion. California alone has more payday loan offices—nearly 2,000—than it does McDonalds and Burger Kings, and other states are not very far behind.

No matter how you slice it—and different sources slice it different ways—the nonbank financial services industry earns immense profits. A U.S. Treasury Department study of check cashing and payday lending showed average pretax returns on sales of 34 percent. Payday lenders in Chicago, according to another study, realized a return on investment of 24 percent. ACE Cash Express, the biggest of the national check-cashing companies, with more than 1,100 outlets, reported average store profits of 23 percent for fiscal year 2001—up 25 percent over a year earlier.

How can we account for this extraordinary growth? The answer lies in an understanding of the needs and the barriers facing the customers of nonbank financial providers. Developing that understanding is a step that mainstream financial institutions must take before they can hope to expand their presence in the underbanked market and provide the underbanked with the benefits of more comprehensive banking relationships.

To assist in that understanding, the Office of the Comptroller of the Currency (OCC) recently sponsored a survey of individuals living in low- and moderate-income neighborhoods of two major urban areas: Los Angeles County and New York City. We polled

over 2000 randomly selected individuals about their financial habits and experiences. From our results we can draw statistically valid inferences about the 2.6 million individuals who live in the low- and moderate-income neighborhoods in these two major urban areas.

One inference that may be drawn from our study is that people who lack formal banking relationships may be just as responsive to market incentives as people who have those relationships. In other words, appearances to the contrary notwithstanding, check-cashing customers, payday borrowers, and consumers of other relatively high-cost nonbank products do business outside the banking system for practical—and economically rational—reasons. This is an exceedingly important point, because it is sometimes mistakenly assumed that people with low incomes lack the acumen to make sound decisions in their own self-interest.

Two complementary realities shape the check-cashing behavior of people without formal banking relationships. First, these individuals generally spend a good deal less in check-cashing fees than one might imagine, given the high per-check fees that check-cashing outlets usually charge. A substantial portion—16 percent—of this segment of our survey population received its income entirely as cash, and thus had no reason to do business with check-cashers. Of those who did receive checks, 23 percent usually cashed them—and usually free of fees—at a bank, most likely the bank on which the check was drawn.

Those who did use check cashers, moreover, tended to use them sparingly. Ninety-seven percent of that population received four or fewer income checks per month; households earning $15,000 a year or less typically received two checks per month. Eighty-five percent of those without formal banking relationships used three or fewer money orders per month. Check-cashing outlets charged an average of $3.38 per check, and an average of $1.00 per money order. Nevertheless, as I've noted, many of those without formal banking relationships did not use check-cashing or money-order services, and not all of those who do use those services obtain them from check-cashing outlets. Thus, when we consider all of those without banking relationships in our study population in New York and Los Angeles, we find that only about one-third of these households wound up incurring total check-cashing and money-order costs of $100 or more per year.

I am by no means belittling the importance of even $100 a year to a low- or moderate-income family—and the reality elsewhere in the country may be different from these findings for two large urban areas. But that may be the best deal available in the current financial services marketplace for people who have to pay for check cashing. As I said, there's a second financial reality that shapes the behavior of check-cashing customers: the fact that while check-cashers charge a lot, most banks charge more for the same services. According to a 1999 study by the U.S. Public Interest Research Group, the average minimum balance required to *avoid* fees for checking accounts at large banks was $616. Consumers who were unable to meet that minimum balance requirement—and a great many simply do not have enough savings to do so—paid an average of $218 a year, or $18 a month, to maintain a checking account. For people who may typically cash only a few checks and make only a few payments per month, such bank accounts do not make sense. Indeed, earlier surveys have strongly indicated that the principal reason people give for not having a bank account is that it costs too much for their needs. And while many banks have developed a variety of inexpensive products appropriate for low-income customers, they are often not well publicized.

In my view, banks that do not now offer these inexpensive products should strongly consider doing so. And those that already have them should do more to bring them to the attention of current and potential customers.

Payday borrowers too often lack good low-cost options. They typically patronize payday lenders not because they are unaware of the high cost of the credit obtained from that source, but because they have few better places to turn. According to a recent Georgetown University study, the typical payday borrower, needing perhaps $200 to deal with an emergency—or simply to bridge from one payday to another—is unlikely to have a usable credit card, an overdraft line of credit, or relatives willing and able to help. As a last resort, they might bounce a check—and face $50 or more in overdraft fees plus the risk of having the account closed—or, if they own their own home, apply for a home equity loan and wait weeks for a line of credit far larger than they actually need. In that light, the $30 or $40 that a payday lender might charge for fast approval of a two-week, $200 loan doesn't seem so far out of line.

It's worth noting here that payday borrowers don't seem to be at all deterred by high annual percentage rates (APRs). The Truth-In-Lending disclosure statements they are given reflect APRs that may range as high as 900 percent, but borrowers seem to focus on the immediate dollar cost rather than the annualized rate.

The real damage, of course, occurs over time. It's not the single payday loan that buries the borrower; it's when payday finally arrives, and the borrower can't comfortably

pay back the loan. Then the borrower must pay another fee to roll the loan over for another two weeks—and then for another. According to the Georgetown study, three-quarters of all payday borrowers renewed their loan at least once, with about 30 percent reporting seven or more renewals. It's when they mount up—when a new loan is taken to repay one that has come due—that the APRs become astronomical and the borrower gets trapped in an increasingly costly cycle.

Similarly, the relatively small sums that people without a formal banking relationship spend to cash a few checks and buy a few money orders are not the problem. It's the compound effect of lost opportunities to build wealth and make a better life that is the problem. It's the cash tucked away—not safely in a savings account, but in a coffee can or hip pocket, vulnerable to theft or loss—that sets people back in their struggle to get ahead. It's a problem measured in homes that will never be purchased, in businesses that will never be built, and in the financial security that will forever remain out of reach.

The loss is one we all share—on many levels. For banks, it's a business loss—and it's an avoidable one. I believe that banks are uniquely positioned to provide options and opportunities that the underbanked currently lack. But doing those things requires first a sophisticated understanding of the market and the opportunities, and second a commitment from banks to fashion products and services that are consistent with reasonable profit expectations and responsive to what these customers want, at competitive prices they can afford.

Prices they can afford, consistent with reasonable risk-related profit. That's the rub. Banks are not in business to give away their services. But the poor and near-poor have limited resources to spend on financial products. We know approximately what those limits are because we know what the underbanked are spending at nonbank outlets today. And some bankers have looked at those numbers and then looked at what it would take to deliver a comparable array of products and services, and concluded that it cannot be done—or that it's too much trouble even to try.

Maybe there was a time they were right. But today's bankers have an ally in the effort to profitably serve the underbanked. The military refers to technology as a "force multiplier"—a means to maximize resources and shift outcomes. It can be that for the banking industry as well, in the effort to profitably serve the underbanked.

Technology has already revealed its potential in this regard. In the Electronic Transfer Accounts (ETA) now being offered by hundreds of financial institutions around the country, we have the prototype of a technology-intensive, utilitarian, low-cost account that has already drawn thousands of previously unbanked Americans into the banking system. The ETA, as you know, allows recipients of many kinds of federal direct-deposit payments to access their funds automatically through debit-card-based electronic funds transfers (EFT).

Encouragingly, financial institutions are beginning to build on the ETA model, offering enhancements designed to make such accounts more useful and more widely available. Taking advantage of their ability to inexpensively batch remittances, some banks are beginning to develop ETA-like accounts that combine direct deposit with bill payment options. Such accounts are proving attractive to individuals accustomed to spending several dollars per month for money orders or electronic bill payments for that purpose. For banks, the key is to keep expenses down and paper to a minimum, and technology holds tremendous promise in that regard.

Keep in mind, too, that banks have some significant competitive advantages that should enable them to offer such accounts at reasonable prices. They alone have access to the payments system; they alone can hold transaction balances; they alone can receive direct deposits; they alone have deposit insurance coverage and access to the discount window. And they alone can offer services unique to banks in conjunction with a variety of other services.

Just think what such accounts offer. To the customer, they provide a safe and cheap repository for funds. No more lost or stolen checks; no more hassles to cash a payment check; no more risk of carrying around a wad of cash and becoming a target for predators. The paycheck goes directly into the bank account, and, with a debit card, the customer can draw funds as she needs them at an automated teller machine (ATM) or a point of sale. And, if the bank has been innovative, the customer may even be able to make basic payments from the account by electronic transfer, either without cost or at a cost far less than a money order.

For the bank, there are also important benefits: no processing of paper checks; no risk of overdrafts; establishing new customer relationships that may be developed into something more. For example, if such customers need small loans, for a car or appliance purchases—or even a payday-type credit—a direct deposit account offers the possibility of a prearranged debit or periodic payments, significantly reducing the bank's risk of default.

Banks are also taking the initiative to address the short-term borrowing needs of their customers, and here again, technology can be a big part of the solution. In one noteworthy development, a prominent national bank has begun to offer a product that provides access to low-cost cash advances for direct deposit customers. Funds can be obtained directly from the bank's ATM network or by speaking to a telephone agent who will transfer the funds into the customer's account. The bank has also automated the underwriting process, cutting costs for both parties to the transaction and virtually eliminating the waiting period for established customers—a matter of considerable importance, as we've seen, for the emergency borrower.

Obviously there are many hurdles to be cleared before such innovations can be judged a success. We have to encourage greater participation in direct deposit. Direct deposit is one of those rare win-wins: employers enjoy significant savings in payroll processing costs; banks gain new business and retail customers; and employees avoid the worry and expense of handling paper checks.

Yet this is an area in which the United States has lagged well behind many other advanced nations—and in which the private sector has lagged behind government. Today, as a result of the EFT 99 legislation, 77 percent of all government payments are made electronically. Seventy-five percent of Social Security payments are made by direct deposit, and at agencies like the OCC, virtually 100 percent of salary payments are deposited directly.

One way we may be able to raise participation rates, as I've already mentioned, is to tie other useful products and services—especially those that can be delivered electronically—to direct deposit accounts.

If banks are to compete effectively against the storefront lenders and check cashers, they will also need to rethink their branching strategies and focus on refining their delivery systems and making them user-friendly. Some customers continue to report being deterred by what they view as an intimidating atmosphere in the typical branch, an objection that banks used to brush off when they could afford to be indifferent to the underbanked market. These days, banks seem to be taking such objections more seriously—a development that may herald a new, more constructive attitude toward this market. Some institutions have acquired check-cashing and payday-lending outlets, where customers can select from the menu of financial products and services in the atmosphere they're accustomed to, while being gradually exposed to the potential benefits of mainstream banking.

Bringing more people, more fully, into the banking system must be a part of any strategy to improve the standard of living in our country. That's a goal I know we all share; it's the goal that has brought us to Baltimore this week.

The OCC is very proud to be the co-sponsor of this event, which holds tremendous promise for our communities and our financial institutions. For those of us in the financial regulatory community, lending assistance in the effort to build bridges to the underbanked is an important part of our official duties. For financial institutions, reaching out to new markets is not only a civic responsibility. It can also be a good business.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the National Association for Business Economics, on the global economy and the role of the OCC, Washington, D.C., March 25, 2002

There's a new realism in our thinking about the global economy. We now have a keener awareness of the special security challenges—as well as the more familiar political and financial challenges—that internationally active businesses have to contend with.

This awareness has been forced on us by recent events. The world is a different place today from six months ago. It may stay that way. And that means adjustment—by all parties—to the realities of the new international environment.

By arranging this timely conference on the new uncertainties of the global economy, the NABE has materially contributed to this cause. I congratulate you—and I thank you for the opportunity to be here with you today.

This more balanced, more cautious, perspective on the global economy is an enormously positive development. To the extent that it contributes to a better deployment of our finite stock of human and financial assets, I believe it bodes well for the future of international trade and investment—and, therefore, for our collective well-being.

Let me go further and suggest that the most commonly cited benefits of globalization—new markets, access to innovation, comparative advantage and specialization—are not the *only* important benefits that globalization has brought us.

I am not by any means discounting the importance of the bottom line—probably the second most powerful animating force known to mankind. But I do believe that we're profiting from the global convergence of financial practice—and a similar convergence in financial oversight and supervision—in other ways that have little to do directly with dollars or deutschmarks. Convergence has given us a wider range of experiences on which to draw—and from which to learn.

As U.S. bank supervisors, we're intensely interested in the experiences of our supervisory colleagues around the world. We work closely with them, both bilaterally and through the Basel Committee on Banking Supervision. It's part of our ongoing effort to raise bank supervisory standards and practice—and to bring them into greater harmony among both the advanced nations of the world and the world's emerging economies.

In the United States, our interest in the structure and operations of bank supervision in other nations isn't simply a matter of professional curiosity; it goes deeper than that. For more than a century, the structure of bank supervision in the United States has been a controversial subject. And although U.S. lawmakers have frequently tinkered with that structure, it's resisted fundamental change.

As someone who has spent the better part of a long career working within that structure, I confess to a certain affection for it, in all of its convoluted glory. Moreover, the system works quite well, and the various players have learned how to live with it.

But there are some who think that it's not enough that a system works in practice. They believe it should work in theory as well—and our bank supervisory structure probably fails that test. It's not uncommon for those who have not lived within the present system to view it with chagrin on first exposure. Understandably, it presents an inviting target for rationalization and restructuring.

What the structure of bank supervision in the United States would look like if we were designing it from scratch is an interesting and provocative subject for those of us involved in the supervisory process.

But it's not the subject I'll be addressing today. There's no reason to bog you down in the arcane politics of bank supervision and regulation, or in the details of how our system compares with those in other countries.

Indeed, one of the lessons we have already learned from the Basel Committee's work on a new international capital accord is that it's very difficult to find common institutional arrangements suitable for all countries at all times.

This shouldn't come as a surprise. Institutions spring uniquely from a country's culture and history. Whatever else one might say about the U.S. supervisory structure, which has emerged largely through historical accident, it's come to reflect distinctively American values and habits—

suspicion of authority (especially centralized authority), competition, and egalitarianism.

The structure of our banking system is also uniquely and authentically American. We would not graft our model onto another country and expect it to work, just as we might find that any particular foreign model might fail to gain acceptance here. I think that most Basel Committee members would agree that the range of national practices in financial services and supervision worldwide is *too* wide to be accommodated within a single uniform framework.

But where the Basel Committee *has* been quite successful—in its previous work as well as its current work—has been in identifying common *principles* of effective supervision and leaving it to each nation to decide how those principles should be implemented.

One such principle emerges with striking frequency and clarity from the recent history of financial crisis in countries around the world. Nearly every crisis we examine, no matter where it occurred, provides a reminder of the dangers of politicizing the banking system and its supervision.

We see such interference taking various forms. Central governments may compel banks to make loans in defiance of good credit practices in order to promote certain policy goals, such as protecting inefficient industries. Governments may take an ownership interest in the banking system to facilitate such policies. In some cases, government pressure has forced financial institutions to lend to weakened, but politically powerful, companies or industries.

Pressure may be exerted on supervisory authorities to forbear, or "look the other way," when a bank's condition has deteriorated and supervisory action would be warranted. In some cases, court decisions, legislative action, or other informal influences have undermined supervisors. Where supervisors are removed from office without cause—and appointed to office without regard to their professional competence—the quality of bank supervision inevitably suffers.

But though the means may vary, using the banking system to advance a political agenda rarely succeeds in the long run. Where short-term expediency is given primary weight, the safety and soundness of financial institutions is frequently undermined. And when that happens, the banking system's ability to support an economy's growth and well-being is surely compromised.

I believe that the evidence of specific national cases bears this out.

In some respects, Argentina stands as a textbook example of the dangers of politicizing the banking system, because the consequences there have been so sudden and dramatic. What had been South America's breadbasket—and one of its most vibrant economies—is now an economic basket case, suffering high and rising unemployment and remote prospects for recovery any time soon.

Although a great many factors contributed to the country's decline, it can be argued that Argentina's downfall was sealed in late 2000 with the launching of a series of official actions that had the effect of crippling the nation's banking system. Banks, as well as pension funds, were pressured into relaxing their limits on holding government debt. A committed safety-and-soundness advocate was ousted from his position as governor of the central bank.

The banking system itself was pushed to the brink of insolvency when the government asymmetrically "pesofied" dollar-denominated bank deposits and assets, a move that decimated bank capital. And the imposition of deposit withdrawal limitations destroyed what little public confidence remained in the system. As a result of the country's liquidity crisis, new loans that might help revive the economy are difficult to come by and Argentina's downslide continues—regrettably with no end in sight. It will take many years for the banking system to recover.

Japan's economic problems have also been well chronicled, and the role of a weakened banking system in aggravating those problems is well documented. Not as well recognized is the role played by Japanese bank supervisors, then directed by the ministry of finance, in keeping insolvent institutions afloat.

Reluctant to take action against these institutions, Japanese regulators allowed them to bleed slowly, draining resources that might have aided the country's recovery. A new unified Financial Services Agency, responsible to the prime minister's office, was created to correct the problem. But in part because the habits of regulatory paternalism and opaqueness are proving hard to eradicate, stagnation continues to characterize Japan's economy.

South Korea offers another illuminating primer on how even well-intentioned government actions can undermine a banking system's safety and soundness. Among the fundamental weaknesses in the Korean banking system as late as the mid-1990s was the truly massive scale of the Seoul government's directed lending program.

For years, industries earmarked for support in its export-oriented economy received government-subsidized loans, among many other things. Bank supervisors, through lax supervision, had become instruments of this policy of propping up favored borrowers. Supervisory responsibility was divided between the central bank and the ministry of finance.

But the quality of South Korean supervision, rather than its structure, was the biggest problem. Prudential supervision standards were lax. Banks were not required to undertake in-depth analysis of commercial borrowers. Loans were repeatedly rolled over without meaningful review of the borrowers' abilities to repay. Regulatory limits on concentrations of credit to a single borrower were loose, and they were widely suspended in dealing with favored borrowers. Banks were permitted to grow without adequate risk management safeguards.

When the South Korean economy crashed in 1998, the banking system led the way down. Wisely, the Seoul government recognized the role that inadequate supervision had played in the debacle, and in that year, it undertook a comprehensive restructuring of the country's oversight of financial institutions. Supervision was consolidated into a single agency, independent of the government, and prudential regulations have been brought closer in line with international best practices. At least part of the credit for South Korea's progress toward recovery must go to its effort to reform its supervisory structure—and to the international donor agencies that encouraged it to act.

South Korea seems to have learned from its experiences. So has Turkey. Supervisory changes have been an essential part of the reform efforts initiated by the Turkish authorities over the last several years, and were among the conditions of the International Monetary Fund's 1999 aid package.

Turkey's financial instability has been the result of a combination of factors, including government interference in the state-owned banks. These banks have incurred huge losses due to directed lending. Fragmented, ineffective supervisory oversight was also a factor. But Turkey is enacting sweeping changes in its national supervision, including the creation of a new, independent, professional regulatory body to do the job previously performed by several government entities. Turkey still faces significant hurdles. But most analysts agree that while the country has a way to go, it's headed in the right direction.

There's a final example I'd like to discuss—an example considerably closer to home. The independence of bank supervision in the United States itself has often come into question.

It's a question that has a long and difficult history. During the Great Depression of the 1930s, there was strong sentiment that federal bank supervisors should take marching orders from their superiors in the Treasury Department and from the Federal Reserve. Many people thought that the Comptroller of the Currency should encourage national banks to make loans to good borrowers and bad borrowers alike, and to look the other way as credit quality deteriorated.

Given the gravity of that crisis, with the very survival of the U.S. economy perhaps hanging in the balance, this viewpoint might have been understandable. But had it prevailed, the result could have been disastrous for the banking system, for the federal supervisory agencies, and for the U.S. economy. Fortunately, more sensible heads prevailed, and the statutory firewalls that were designed to protect our independence and shield us from improper influences did their job.

That was not the last of it, however. Over the decades, there have been occasional attempts to draft federal bank examiners into the service of some larger political or economic strategy. For us that's meant contending with pressures that have arisen from time to time to alter our supervision in ways that may be expedient—but may also be fundamentally unsound.

The late 1980s and early 1990s, for example, were a time of great stress in the U.S. banking system and the U.S. economy. The Office of the Comptroller of the Currency was encouraged to overlook weaknesses in the balance sheets of some troubled banks in the hope that the economy would improve and the banks in question would turn the corner on their own. Some called this watchful waiting; a better term might have been wishful thinking.

As it turned out, we did no one any favors—certainly not the affected banks—by allowing problems to go uncorrected. Losses mounted, forcing us finally to take precipitous action to deal with what were by now deeply troubled, if not insolvent, banks. Loans that passed muster in one examination were severely criticized in the next, as examiners demanded large additions to loan loss reserves previously thought adequate—with serious consequences for the credibility of supervisors, among other things.

Many banks failed; bank credit became increasingly difficult to come by, generating talk—and it was mostly talk—of a "credit crunch" ostensibly caused by bank

supervisors. But it's certainly true that the banking system's troubles complicated and prolonged the process of economic recovery a decade ago.

This experience is one that we've been determined to learn from—and never to repeat. It taught us that ignoring or failing to comment on increasing risk or deteriorating conditions—forbearance, to call it what it is—is poor supervision. It reminded us that we serve our banks best when we forthrightly convey our concerns to bank managers and encourage them to address changing circumstances.

It caused us to reaffirm our commitment to the proposition that we best serve the public interest by overseeing the safety and soundness of the national banking system consistently, predictably, and independently, in good times and bad. We make our greatest contribution to a sound economy by assuring that our banks have the capacity to extend credit when creditworthy loan opportunities are presented.

I believe the results speak for themselves. While there are pockets of weakness in the banking system today and the possibility of additional problems ahead, those problems are much less widespread—and much more manageable—than they were at a comparable stage of the last business cycle.

Capital is high—twice as high as it was in 1989. As one might expect after two years of business slowdown, nonperforming assets are up, but not alarmingly so. Loan loss provisions are adequate, even if not as conservative as bank examiners might wish. Overall, the industry is still highly profitable—again, no small accomplishment given the recent condition of the economy.

And here's another quite remarkable development. Although the evidence shows that U.S. banks have gradually been raising their lending standards—a positive development, in our opinion—business credit is still plentiful—much more plentiful than at any similar time since the early 1970s, according to a new Federal Deposit Insurance Corporation study. So much for credit crunch allegations—which seem to emerge principally from marginal borrowers whose banks have prudently cut back on their lines.

Perhaps the foremost reason for the improved availability of business credit is that the banking system has generally remained healthy despite what was until recently a down economy. And now that loan demand is poised to pick up again, banks will be in a condition to respond, and the economy will have the capital it needs in order to resume its upward growth.

Before we become too totally intoxicated with our own accomplishments, however, let me offer two quick caveats. First—and I can't stress this enough—it's important that we not indulge in premature celebration over the news from the front, as it were, because conditions on the battlefield are subject to change. As I said at the outset, the new global economy undoubtedly has many surprises in store for us in the months ahead, and any sense of relief and satisfaction we might feel over the present condition of the banking system must be leavened by a large measure of caution—and humility.

Second, I am not suggesting that bank supervisors deserve all—or even most—of the credit for the banking system's current health. Many of the changes that have taken place over the last decade, and have helped buffer the industry against hard times, have come from bankers themselves.

Banks are much more diversified in their product lines and less concentrated geographically than they were just 10 years ago. That makes them less vulnerable to the kinds of local disturbances that proved so ruinous to financial institutions during the recession of the early 1990s. They have recognized the need for strong capital bases. They have reduced their reliance on volatile interest income, have diversified their revenue streams, and they have invested in advanced risk management techniques that make it possible for them to better measure and manage their risk and thus to limit their exposure to loss.

Bankers too have learned from the last downturn. The historically high levels of capital in the system today are a reflection of the experiences of a decade ago, when adequate capital—by regulatory standards—turned out in some cases to be wholly inadequate to cover the actual volume of loan losses. Some bankers vowed that this would never happen again. And tougher capital regulation reinforced that lesson for bankers who might have missed it on their own.

Clearly, we have all learned from experience.

Yet one can't discount the contribution that bank supervisors have made to the industry's health. Bankers certainly don't. Sometimes it's as simple as our taking the blame for a politically awkward decision by a bank, such as declining a longstanding customer's request for a questionable loan. In that spirit, let me say this to the world: we're happy to serve as any banker's scapegoat if it results in a safer and sounder banking system.

And bankers often express their appreciation to us for helping them recognize weaknesses and arrange appropriate corrective action.

For example, two years ago we became very concerned about the volume of “enterprise value” lending we were seeing—that is, credits whose repayment depended on the borrower’s success in realizing projected cash flows, frequently from start-up ventures. We viewed this as no more than a very chancy kind of unsecured lending—or, perhaps more accurately, as a kind of equity investment, without any upside.

We knew we were on to something when we heard loan officers refer to these credits as “airball” loans. We heard some carping about our repeated comments on this subject, but I believe our focus on this practice served banks well. Just recently, one of the country’s leading bankers said to me, somewhat apologetically, “You guys were absolutely right about that enterprise value stuff.”

The past 24 months—and the past six months especially—have been a trying time for the American economy and the American people. Yet, in part because bank supervisors have been resolute in facing the facts and in addressing problems in the banking system as we saw them developing, I believe the American people are better off. Because we have been able to provide not just quality supervision, but independent supervision, the U.S. banking system is strong today. And thankfully, so is our nation.

Statement of Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, Office of the Comptroller of the Currency, before the U. S. House Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, on regulatory burden on America's banking system, Washington, D.C., March 14, 2002

Statement required by 12 USC 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Bachus, Ranking Member Waters, and members of the subcommittee, I appreciate this opportunity to discuss with you ways in which we can reduce unnecessary regulatory burden on America's banking system, and to express the views of the Office of the Comptroller of the Currency (OCC) on the Financial Services Regulatory Relief Act of 2002 (FSRR Act).[1] Let me also thank Ms. Capito, for sponsoring a bill that includes sensible and appropriate regulatory burden relief for national banks and other financial institutions.

Effective bank supervision demands that regulators achieve a balance among several competing, but equally important, objectives. These objectives include fostering banks' ability to conduct their business profitably and competitively, free from burdensome constraints that are not necessary to further the purposes of the banking laws. Unnecessary burdens drive up the costs of doing business for banks and their customers and prevent banks from effectively serving the public. Periodic review of the banking statutes and regulations is an essential means of ensuring that banks are not needlessly encumbered by requirements that are no longer appropriate for today's banking environment.

The OCC itself has a continuing commitment to review its regulations and make changes, consistent with safety and soundness, to enable banks to keep pace with product innovation, new technologies, and changing consumer demand. We also constantly reassess the effectiveness and efficiency of our supervisory processes to focus our efforts on the institutions and activities that present the greatest risks and to reduce unnecessary burdens on demonstrably well-run banks. However, the results that Congress can achieve by removing or reducing regulatory burden imposed by federal statutes can be broader and more far-reaching than regulatory changes. The FSRR Act contains a number of important provisions that will help national banks remain profitable and competitive by eliminating unnecessary burden. The first portion of my testimony will highlight several of these provisions.[2]

A second, and fundamentally important, objective of our supervision is to promote and maintain the safety and soundness of the banking system. The FSRR Act also contains provisions that further this objective, and I will mention a few of these provisions in the second section of my testimony. I will also take this opportunity to briefly discuss certain additional legislative changes that you may wish to consider as the legislation is developed, which would help promote safety and soundness.

National Bank Provisions

The FSRR Act contains several provisions that would streamline and modernize aspects of the corporate governance and interstate operations of national banks. The OCC strongly supports these provisions.

For example, section 101 of the act relieves a restriction in current law that makes it difficult for some national banks to operate as "Subchapter S" corporations. The National Bank Act currently requires all directors of a national bank to own at least $1,000 worth of shares of that bank or an equivalent interest in a bank holding company that controls the bank. The requirement means that all directors must be shareholders, making it difficult or impossible for some banks to comply with the 75-shareholder limit that defines eligibility for treatment as a Subchapter S corporation. These banks are thus ineligible

[1] As of the time this testimony was required to be submitted, the FSRR Act had not been formally introduced. Accordingly, the views of the OCC set forth in this testimony are based on the March 5, 2002, Discussion Draft of the FSRR Act, including certain changes that we have been advised will be made to the draft. References to sections of the act are based on the March 5 Discussion Draft. The OCC will be pleased to work with subcommittee staff, as appropriate, as the legislation progresses.

[2] A detailed section-by-section review of the provisions of Title I, IV, and VI of the March 5, 2002, Discussion Draft of the FSRR Act, which are relevant to the OCC's responsibilities, is attached to this testimony as an appendix.

for the benefit of Subchapter S tax treatment, which avoids a double tax on the bank's earnings. Community banks suffer most from this result.

Section 101 authorizes the Comptroller to permit the directors of banks seeking Subchapter S status to satisfy the qualifying shares requirement by holding a debt instrument that is subordinated to depositors and general creditors of the bank. The holding of such an instrument would not cause a director to be counted as a shareholder for purposes of Subchapter S. The subordinated liability is closely equivalent to an equity interest, however, since the directors could only be repaid if all other claims of depositors and nondeposit general creditors of the bank were first paid in full, including the claims of the Federal Deposit Insurance Corporation (FDIC), if any. The new requirement would thus ensure that directors retain the requisite personal stake in the financial soundness of their bank.

Similarly, section 102 of the act eliminates a requirement in current law that precludes a national bank from prescribing, in its articles of association, the method for election of directors that best suits its business goals and needs. Unlike most other companies and unlike state banks, national banks cannot choose whether or not to permit cumulative voting in the election of their directors. Instead, current law requires a national bank to permit its shareholders to vote their shares cumulatively. Section 102 provides that a national bank's articles of association may permit cumulative voting. This amendment would conform the National Bank Act to modern corporate codes and provide national banks with the same corporate flexibility available to most corporations and state banks.

Section 401 of the act also simplifies the requirements that apply to a national bank that wishes to expand interstate by establishing branches *de novo*. Under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, interstate expansion through bank mergers generally is subject to a state "opt-out" that had to be in place by June 1, 1997. Under the time frames set by the statute, interstate bank *mergers* were permissible in all 50 states as of September 2001. By contrast, *de novo branching* still requires states to pass legislation to affirmatively "opt-in" to permit out-of-state banks to establish new branches in the state.

This effect of current law is to require that, in many cases, national banks must structure artificial and unnecessarily expensive transactions in order to establish a new branch across a state border—which in some cases, is simply across town in a multi-state metropolitan area. Section 401 repeals the requirement that a state expressly must adopt an "opt-in" statute to permit the *de novo* branching form of interstate expansion for national banks and contains parallel provisions for state member and nonmember banks. National banks and their customers would benefit significantly by this change, which would permit a bank to freely choose which form of interstate expansion is most efficient for its needs and customer demands.

Safety and Soundness Provisions

The FSRR Act also contains a number of provisions that further the objective of promoting and maintaining the safety and soundness of the banking system. One of the most important of these provisions (section 406 of the March 5, 2002, Discussion Draft), expressly authorizes the federal banking agencies to enforce written agreements and conditions imposed in writing in which an institution-affiliated party or controlling shareholder agrees to provide capital to the depository institution. This provision would supersede recent federal court decisions that conditioned the agencies' authority to enforce such conditions or agreements on a showing that the nonbank party to the agreement was "unjustly enriched." These changes will enhance the safety and soundness of depository institutions and protect the deposit insurance funds from unnecessary losses.

The act also contains two provisions that promote safety and soundness by providing the federal banking agencies with greater flexibility to manage resources more efficiently and deal more effectively with problem situations. Current law mandates that most banks be examined on site on prescribed schedules. This can, in certain circumstances, interfere with the ability of the banking agencies to concentrate their supervisory oversight on deteriorating or problem institutions. Section 601 of the bill would permit the agencies, when necessary for safety and soundness purposes, to adjust their mandatory examination schedules to concentrate resources on particularly troublesome institutions.

Current law also provides for criminal penalties to be imposed on a federal bank examiner who examines a bank from which the examiner receives an extension of credit, including a credit card issued by that institution. This limits the flexibility of the OCC and the other banking agencies to assign examiners to particular institutions or examination teams, even if the examiner's skills or expertise would contribute materially to the examination. Section 602 provides that federal banking agency employees may have credit cards without disqualification or recusal, but subject to the safeguard that the cards must be issued under the same terms and conditions as cards issued to the general public.

Additional Safety and Soundness Enhancements

The OCC has identified several additional areas in which amendments to current law would enhance the banking agencies' safety and soundness authority, reduce risk to the deposit insurance funds, and facilitate our enforcement efforts when wrongdoing does occur. We would be happy to work with the other banking agencies to further develop these recommendations and with subcommittee staff to facilitate inclusion of the agencies' recommendations in the FSRR Act as it is developed through the legislative process.

Under the Change in Bank Control Act (CBCA),[3] all acquirers of insured depository institutions are required to provide notice to the appropriate federal banking agency before proceeding with an acquisition. The CBCA gives the agency a specified time period within which to object to the transaction and specifies several bases on which the agency may disapprove a change-in-control notice. It does not, however, expressly permit the agency to impose conditions on the institution in connection with the agency's failure to object to an acquisition of control. While we think the ability to impose conditions designed to ensure the safety and soundness of the bank being acquired may be fairly inferred from the purpose of the statute, in order to eliminate any ambiguity, we recommend that the CBCA be amended to expressly permit the appropriate federal banking agency to impose conditions it determines advisable for safety and soundness reasons, in connection with its decision not to pose objection to a CBCA notice.

We also recommend amending the CBCA so that acquirers of entities possessing dormant bank charters would be subject to the same standards and conditions—including participation by the Federal Deposit Insurance Corporation (FDIC)—as are required when an applicant seeks a *de novo* bank charter. In such a case, acquirers are effectively buying a bank charter without the requirement for prior approval and without the scope of review that the law imposes when applicants seek a new charter, even though the risks presented by the two sets of circumstances may be substantively identical.

Another change that we would support is to clarify that an appropriate federal banking agency may issue cease-and-desist orders against an insured depository institution or an institution-affiliated party who violates conditions imposed by agreements made with *another* appropriate federal banking agency. This issue can arise, for example, when a bank that is subject to requirements imposed by one agency in connection with an application or an enforcement action, converts its charter so that it is regulated by a different agency. Another example occurs when the FDIC imposes conditions in connection with granting deposit insurance but the FDIC is not the appropriate federal banking agency for the insured bank, e.g., a national bank or a state member bank.

In addition, we recommend amending the Federal Deposit Insurance Act to remove the "knowing or reckless" element from the definition of "institution-affiliated party." Under current law, an accountant or other independent contractor of an insured depository institution may be subject to sanctions as an institution-affiliated party in an administrative enforcement action only if the accountant's (or other independent contractor's) wrongful conduct was "knowing or reckless." Accountants who serve as independent contractors to insured depository institutions play a key role in keeping institutions' books and records accurate. In recent years, banking regulators have seen an increase in audit and internal control deficiencies at many insured depository institutions, some of which have caused significant operating losses and led to failures of institutions. Elimination of the "knowing or reckless" standard would remove a significant impediment to the agencies' ability to hold these individuals and firms accountable for violations of law, breaches of fiduciary duty, or unsafe or unsound practices.

Conclusion

Once again, Mr. Chairman, on behalf of the OCC, I thank you for your leadership in pursuing this legislation. As I have indicated, the OCC supports the act and believes that many of its provisions will go far to promote the objectives I have described today. In those areas where we have recommended that you consider additional amendments, we would be pleased to work with your staff to develop appropriate legislative language for the subcommittee's consideration.

I am pleased to have had this opportunity to provide our views on this important initiative, and I would be happy to answer any questions you may have.

[The attachment can be found electronically at http://financialservices.house.gov/media/pdf/031402jw.pdf]

[3] 12 USC 1817(j).

Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, Office of the Comptroller of the Currency, before the Mid-Atlantic Bank Compliance Conference, on compliance and section 5 of the Federal Trade Commission Act, Annapolis, Maryland, March 22, 2002

I am very pleased to have this opportunity to speak with you this afternoon. Compliance is a formidable challenge for bankers these days—you don't need me to tell you that. Compliance requirements are many, and many of those requirements are detailed and technical. But compliance also has more dimensions than simply satisfying a complicated set of disclosure requirements. Compliance issues also touch on essentials of bankers' relationships with their customers, on their commitment to treating customers fairly, and on their fundamental principles for customer service.

Compliance is an essential—but not the exclusive—element of a bank's overall strategy for good customer service. Individual consumers may not know precisely if their bank has complied with all the applicable compliance rules, but they immediately know, and have no problem reacting, when they feel they haven't been treated right by their bank. What I'll talk about today is a question that is at the intersection of compliance and customer service—

> "When do marketing practices reach the point that they are not just bad customer service, but also unfair or deceptive practices contrary to law?"

First, I'll describe the contexts where we see this issue coming up. Next, I'll describe some steps the Office of the Comptroller of the Currency (OCC) has taken to address practices that we felt were unfair and deceptive. Then finally—and most importantly—I'm going to offer some guidance on how to *avoid* this type of compliance and customer service problem. Today, the OCC is issuing an advisory letter as part of our efforts to identify potentially problematic practices and provide guidance to national banks on how to avoid them. I'll be describing that advisory letter as part of my remarks today.

Background

Let me begin by describing a bit of the current environment that can give rise to these issues.

Banks' reliance on non-interest income has grown significantly during the 1990s, and has increased to almost half of the operating income of many commercial banks in recent years. Non-interest fee income is being generated from new sources in an ever-expanding array of products and services that banks offer. At the same time, competition to establish—and retain—customer relationships is greater than ever before. Banks recognize the importance of increasing their product offerings to their existing customers, while, at the same time, it has become easier for customers to switch to another financial institution that appears to offer them a better deal.

One way in which banks are competing is by doing more and more marketing. For example, general mailings of credit card solicitations have grown more than fourfold in recent years, to approximately 4.9 billion (or 39 per household) in 2001. Advances in information technology, and the greater availability and sophisticated use of credit bureau information, have made "pre-approved" solicitations for credit cards commonplace in many, many American households. Banks also supplement their own efforts by using agents, like telemarketers, to market the bank's own products and services, and by enabling third-party vendors to offer their products and services to bank customers.

These developments create increased risk that a bank, or an agent or vendor that a bank uses, may engage in over-aggressive marketing efforts that may cross the line and become unfair or deceptive acts or practices. One consequence of this is that the bank may be exposed to liability from private lawsuits or government enforcement actions. Equally important, engaging in these practices undermines a bank's reputation for fair treatment and fair dealing with its customers, and, as a result, harms its ability to retain customers and preserve valuable sources of income.

OCC Authority to Address Unfair or Deceptive Acts or Practices

When a bank's marketing practices cross the line from being bad customer relations to become unfair or deceptive practices, the OCC (and the other federal banking agencies) have authority to intervene. Provisions of the Federal Deposit Insurance Act allow the OCC to initiate cease-and-desist proceedings and to take other appropriate enforcement actions against a bank if the bank has violated any "law, rule, or regulation."

One *law* that can be violated by banks is section 5 of the Federal Trade Commission Act (FTC). This provision declares, in sweeping terms, that "unfair or deceptive acts or practices affecting commerce . . . are unlawful." The FTC Act also expressly provides that the Federal Trade Commission may take actions to prevent violations of section 5 *by nonbanks*, but it does not refer explicitly to the authority of any banking agency to enforce section 5 against banks. In addition, another section of the FTC Act requires the Federal Reserve Board (FRB) to issue regulations defining specific acts and practices by banks as unfair or deceptive, which would be enforced by the banking agencies.

The question that has been raised recently is whether banks can be held accountable by the banking agencies for violations of section 5 of the FTC Act itself—or only for violations of a Federal Reserve Board regulation that provides that a specific practice is unfair or deceptive. The answer to that question, from our perspective, is clear just by looking at the FTC Act itself. The act does not exempt banks from its prohibition on unfair or deceptive practices nor does it provide that enforcement of FTC Act *regulations* is the *exclusive* method for enforcing the FTC Act.

The answer also is clear if you look at the legislative history of the FTC Act and its amendments. The legislative history does *not* suggest that when Congress amended the FTC Act to let the Federal Reserve Board issue regulations, it intended to cut back on the authority the banking agencies already had to enforce the general ban on unfair or deceptive practices in section 5. If Congress had intended that, the OCC, the Federal Deposit Insurance Corporation, and the Federal Reserve would be left powerless to prevent a bank from engaging in blatantly unfair or deceptive practices that harmed consumers until the Federal Reserve Board issued a regulation declaring those specific practices to be unlawful under the FTC Act. It is simply implausible that Congress would have intended to create such a void.

To put it simply, we believe that if a bank engages in a practice that is unfair or deceptive under the FTC Act, but that has not been defined as such in a Federal Reserve Board regulation, it has nevertheless violated a "law" and the banking agencies can use their enforcement authority to address the violation.

Recently, three courts have issued decisions that support this position. The Rhode Island Superior Court has expressly recognized the OCC's authority to enforce section 5 of the FTC Act in two rulings. In reaching its decisions, the court also noted the need for uniformity in national banking policy as an additional policy reason for not imposing different state standards on national bank operations and regulatory oversight.

Two *federal* courts also have rendered decisions that recognize the OCC's authority to enforce the FTC Act. The first, *Roberts* v. *Fleet Bank*, was a decision issued in November by the U.S. District Court for the Eastern District of Pennsylvania. The second, *State of Minnesota* v. *Fleet Mortgage Company*, was a decision issued in December by the U.S. District Court in Minnesota.

Standards that Apply to Deceptive Practices

I imagine that you might now be thinking: "Well, what *standards* determine if a practice is unfair or deceptive if that practice isn't specifically described in a regulation?" That's a very fair question to ask. Today, the OCC is issuing an advisory letter on unfair and deceptive acts and practices that will help provide some answers. The advisory letter describes in detail what our standards are, and how they are derived from the *published precedent* of the Federal Trade Commission in its enforcement of the FTC Act. The primary source material for FTC policy under the FTC Act is their two policy statements—the Policy Statement on Deception, issued in 1983, and the Policy Statement on Unfairness, issued in 1980.

To give you a frame of reference, it might be useful for me to take a moment and briefly describe these standards. Under FTC precedent, *deception* exists when a party's representations or omissions are likely to mislead consumers in a material way. According to the policy statement and the OCC advisory letter, three elements need to be met to find an act deceptive.

First, to be deceptive, the act or practice does not need to actually mislead—it just needs to be likely to mislead. So, a showing that consumers were actually misled would not be necessary. Instead, in determining if something is likely to mislead, one must consider the overall impression created by the representations or omissions of information to see how they reasonably could be interpreted. In fact, under FTC principles, fine print disclosures of critical information will not necessarily prevent marketing materials from being deceptive if the overall impression of the materials is deceptive and if consumers are unlikely to read the fine print or be able to understand it.

Second, something is likely to mislead if it is likely to mislead a *reasonable* consumer. Under FTC precedent

and our advisory, the reasonable consumer is a consumer from the class of people to whom the advertisement or solicitation is directed. So, it is also necessary to consider the issue in the context of the group targeted by the particular act or practice.

Finally, any deception needs to be material. “Materiality” means that the deceptive omission or representation is likely to affect the customer’s decision about the product—particularly, if it concerns the cost of the credit product or some other key consideration. Practices that can be misleading or deceptive in a material way include misleading claims about costs of services or products; use of bait-and-switch techniques; and failure to provide promised services.

A practice also may be found to be *unfair* and, therefore, unlawful under section 5 of the FTC Act, generally, if the net effect of the practice is to cause substantial consumer harm that could not reasonably have been avoided by the consumer.

OCC Enforcement Actions Involving Section 5 of the FTC Act

So, how does the OCC become involved in these issues? During the course of a regular safety-and-soundness or compliance examination, through consumer complaints, or through referrals from state authorities, the OCC may become aware of practices by a national bank that may be unfair or deceptive. When these situations surface, the OCC applies the FTC Act standards that I just described. And, we have taken action to address situations where we have found violations.

Almost two years ago, the OCC first used its authority under the FTC Act to take action against a national bank that we determined had engaged in deceptive marketing of credit cards targeted to borrowers with weak credit histories. Let me list a few of the practices that we concluded had “crossed over the line.”

The bank used telemarketers who promoted “maximum savings” for consumers who transferred balances and took out a credit card from the bank. But, the interest rates consumers actually received on the bank’s card were lower by only three-tenths or seven-tenths of 1 percent. If consumers asked for more information about how much the savings would be if they transferred their balances, the telemarketers were instructed not to provide it. And, customers who were dissatisfied with their new rate were charged a *previously undisclosed* 3 percent balance transfer fee if they then closed their account at the bank.

The bank also offered a “Credit Protection” program in connection with its credit cards. By enrolling in this program, customers could avoid making payments for up to 18 months if they became hospitalized or lost their jobs. However, the marketing materials never disclosed several significant restrictions on the program. For example, coverage for involuntary unemployment was available only when the customer had paid three months of premiums, and coverage was limited to the number of months paid in—which could be considerably less than the 18 months’ coverage that was promoted.

As just one more example of the problems we found, the bank marketed one of its cards as a “no annual fee” card, but did not adequately disclose that, to get the card, the customer was required to purchase credit protection coverage—which had an *annual cost* of $156. Consumers that refused to pay for credit protection were, instead, charged an annual fee for the card.

The bank in question entered into a settlement of this matter with the OCC in June of 2000. The consent agreement provided for the bank to pay more than $300 million in restitution to its customers, and for the bank to institute a number of changes to its marketing practices.

The most recent enforcement action by the OCC under the FTC Act was in December of 2001. In that action, we determined that the bank in question also had engaged in deceptive practices with respect to marketing its secured credit card. The bank marketed a credit card to subprime borrowers emphasizing that the card would have a credit line of between $250 and $600; that it could be used for “instant cash”; and that it would have “worldwide acceptance.” The bank also said that the card would help borrowers to “be prepared for emergencies.”

Despite these marketing claims, roughly 80 percent of applicants received a card with a credit line of the minimum $250. Upon approval, $200 was charged to this credit line for the required savings deposit, and other fees up to $56 also were charged. As a result, most consumers had no—or even negative—available credit when the card was issued. As you might imagine, the OCC received a number of complaints from consumers who had believed the marketing claims that they would have a credit card that they could actually *use.*

How Banks Can Manage the Risks

Let me be clear that while I do *not* think there is a widespread problem among banks, we all should be concerned about marketing practices that could be unfair

or deceptive. Not only do these practices harm consumers, they also can pose significant risks to a bank's reputation, its pocketbook, and ultimately, its safety and soundness. The consequences of engaging in these practices can include expensive litigation, enforcement actions, and monetary judgments.

We are issuing our advisory letter on unfair and deceptive acts and practices to help national banks avoid being placed in that kind of jeopardy.

This leads me to offer some common-sense tips, or "best practices," if you will, derived from that advisory letter, that you might want to consider—to manage your institution's marketing programs:

- As part of your *routine* risk management, review marketing materials for accuracy and to ensure that they fairly and adequately describe the terms, benefits, and material limitations of the product or service being offered. Don't paint a rosy picture in your marketing that is belied by fine print or the terms that are actually likely to be offered. It's important for consumers to receive the information they need about products or services—including any material limitations—without having to do "detective" work or hunt for a magnifying glass.

- If there is a significant possibility that consumers will not receive the terms that have been advertised, that possibility should be made apparent, and you should avoid using terms that might suggest otherwise, such as "fixed for years," "guaranteed," and "pre-approved." A clear, up-front disclosure describing any contract provision that allows you to change the credit terms you have agreed to will go a long way toward preventing customer confusion and, possibly, litigation.

- If you promote a product or service by highlighting particular benefits, make sure that the benefit won't be cut off by exercising a contractual change-in-terms provision or by some other aspect of the transaction. As I mentioned, the OCC found that a bank engaged in deception when it promoted a credit card as having "no annual fees," but required the borrower to purchase a credit protection product for $156 a year.

- As another part of sound risk management, get clear and affirmative consent from consumers if you sell products and services through telemarketing.

- If you offer "free trial periods" in connection with products or services, make it clear if the consumer will be required to cancel the service at the end of the trial period to avoid being billed for service past the trial period.

- And, finally, make sure you have appropriate procedures in place to ensure that consumer complaints and other communications are reviewed for indications that consumers might have been misled.

Conclusion

A challenge bankers face today, in an increasingly competitive business, is to not fall victim to a lowest common denominator approach to marketing—in other words, "My competitors are doing this, why shouldn't I?" The answer to that question ought to be obvious. This is not just a compliance issue. Your customers are your bank's lifeblood. Gaining them and *retaining* them goes to the heart of your future business. Institutions that engage in unfair or deceptive acts or practices will be held accountable—accountable through judgments and penalties *and* accountable through loss of customers and public trust.

As I said at the outset, consumers may not know if particular activities are contrary to legal standards, but they *do* know when they feel they have been misled or haven't been treated right—and they can easily switch their business to another institution. In fact, many of the consumers that were affected by the deceptive practices at issue in the enforcement actions I described did just that.

Banks not only can meet this challenge, they can surpass it. We should not expect consumers—even financially sophisticated consumers—to have to read marketing and other information for hidden meaning, or obliquely stated conditions and limitations, as if they were trained investigators—or heaven forbid—lawyers. Instead, banks can use their position as trusted and highly respected businesses to promote first-class customer relations and the highest integrity in marketing practices for financial products and services.

Take a look at the guidance in our new advisory. Review your marketing materials and practices, and take the steps you need to "get it right." It will help keep you out of trouble—and it's good business.