Speeches and Congressional Testimony—July 1 to September 30, 2003

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Of the Comptroller of the Currency

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the Federalist Society, on predatory lending and federalism, Washington, D.C., July 24, 2003

For more than two decades, the Federalist Society has been aiding in the analysis and understanding of complex policy issues. This morning's sessions brought together a particularly distinguished group of experts to discuss the problem of predatory lending and federalism. I'd like to express my gratitude to Jerry Loeser for the opportunity to address this important subject from my vantage point as the supervisor of the national banking system.

I should point out that the perspective of the Comptroller's Office embraces many others, including some that you've already heard this morning. It includes the interests of the national banking system itself. But it also embraces the interests of the communities and consumers the system serves, as well as the larger interests of the national economy that system was created to support.

For 140 years, the OCC has been an instrument of federal authority in an arena that, throughout that period, has been the subject of particularly vigorous controversy with the states. That's because the stakes in the financial arena—political as well as economic—are enormous. It's sometimes forgotten that the 1819 Supreme Court decision in *McCulloch vs. Maryland*, a great test case of our fledgling federalism, was at heart a banking case — the first of many federal court decisions in which efforts by a state to assert control over a federally created banking institution have been overturned. Today, the OCC continues to occupy a position at the leading edge of this historic confrontation between state and federal authority.

It should also be remembered, of course, that if the Congress that created the national banking system had had its way, federal dominance in banking would today be an accomplished fact and state banking would be a long faded memory. In the *McCulloch* decision, Chief Justice Marshall had memorably written that "the States 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—in that case, the federally chartered Second Bank of the United States.

Specifically, the state of Maryland sought to tax the Second Bank, an effort that the Court firmly rejected, declaring that "the power to tax involves the power to destroy." And destruction was exactly what Congress had in mind 46 years later when—disappointed with the volume of conversions from state charter to the new national charter—it passed the 1865 "death tax" on the notes of state banks.

As we know, state banks lived on by reverting to deposit banking. And as a result of their tenacity and adaptability, the dual banking system survived, eventually attaining a level of theological importance comparable to the family farm.

Today, the relationship between state and federal banking authorities can perhaps best be described as one of constructive competition. To be sure, Congress has asserted far reaching control over state banks, primarily using the jurisdictional nexus of federal deposit insurance to subject state banks to a broad range of federal regulation relating not only to safety and soundness, but consumer protection, among other areas.

But while Congress has ample authority to assert jurisdiction over state banks, the states' ability to affect the business of national banks is severely limited. It is a Constitutional principle as old and as hallowed as the Constitution itself, deriving from the Supremacy Clause, that creations of federal authority such as national banks are subject to state law only to a limited extent. State-imposed restrictions may not diminish their powers, but nondiscriminatory state laws in areas such as contracts and torts—laws that facilitate rather than obstruct their ability to do business—*are* applicable**.**

So the Supreme Court has repeatedly declared over the past 140 years. Yet scarcely a month passes that the Court's previous rulings on the subject are not the subject of confrontation, as state lawmakers and enforcement authorities continue to attempt to push the boundary back by asserting the right to subject the business of national banks to state restrictions and to subject national banks to the enforcement programs of state agencies.

The OCC will, of course, continue to defend the right of national banks to be free from state efforts to regulate their business, even though our consistent record of success in court—not to mention some very explicit statutory language assigning OCC exclusive visitorial authority over national banks—doesn't seem to prevent this issue from arising again and again.

Perhaps the most interesting of the current challenges to the immunity of the national charter from state regulation centers on the subject of today's conference. Enough has probably been said in this context about the Georgia Fair Lending Act (GFLA) to dispense with a detailed discussion of its particulars. But for those who will be reading these remarks instead of listening to them, let me provide a brief summary of the Georgia law.

The GFLA imposes severe restrictions on so-called "high-cost" mortgage loans, requiring lenders who offer them to comply with a range of substantive and procedural requirements. The practices proscribed under the Georgia law include the financing of credit insurance, debt cancellation or suspension coverage, limitations on late fees and payoff statement fees, pre-payment penalties, negative amortization, increases in interest rates after default, and balloon payments. Certain categories of loans are restricted as to the number of times they could be refinanced and the circumstances under which a refinancing could occur.

Among the GFLA's most controversial provisions is that relating to rights of action for damages against the purchasers and assignees—as well as the originators—of the mortgages covered by the law. This provision threatened to do such harm to the secondary market for covered real estate loans that the Georgia legislature amended the law to modify the standard and narrow the kinds of loans to which the law would apply.

Since the law was passed and amended, much of the focus has been on whether or not federally chartered financial institutions would be subject to it. Shortly after the GFLA was enacted, the Office of Thrift Supervision determined summarily that it was inapplicable to federal savings institutions and their operating subsidiaries. In response to a petition from a national bank for a ruling on whether the GFLA would be preempted, the OCC, as required by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, gave public notice of the bank's petition and asked for comment. Some 75 comments—representing a wide range of interested parties—were received, and we expect our final decision to be released in the very near future.

There is a danger, however, that legal disputation over the preemption of state anti-predatory lending laws may distract us from the more important question: How do we best deal with the problem of predatory lending in our communities while avoiding the creation of impediments to the availability of *nonpredatory* subprime credit?

There's no question that predatory lending exists—and my definition of predatory lending is the aggressive marketing of credit to people who simply cannot afford it. Unscrupulous originators—almost always entities that are not banks or owned by banks—market such credit not based on the borrower's ability to handle it, but on the basis of the borrower's equity—a home. It's no surprise that such loans frequently result in foreclosures.

But the responses of many states and localities, while well-intentioned and aimed at driving financial predators out of business, may have the unintended effect of also making nonpredatory subprime credit harder to come by for those who may most need and deserve it. In Chicago, a municipal law that applied to banks, among others, had the perverse effect of driving more subprime mortgage lending into the nonbank sector, which is precisely where predatory practices are most prevalent. A Philadelphia law that was intended to target predatory lenders apparently persuaded some legitimate subprime lenders to withdraw from that market before the law had even gone into effect—and before the state itself enacted a law that prohibited the Philadelphia law from *taking* effect.

The North Carolina law has been especially well studied, and the results of those studies are revealing. Based on the OCC's analysis, among the mainstream group of subprime borrowers—

those with FICO scores between 580 and 660—mortgage loan originations dropped a stunning 30 percent in the 18 months after the North Carolina law was passed.[1] For the sake of comparison, the same kinds of loans in neighboring states without similar laws fell a scant 3 percent in the same period.

It's no mystery why so many fewer subprime loans are being made—or will be made—in jurisdictions subject to anti-predatory statutes. Studies point to increased compliance costs, especially for banks operating in multiple jurisdictions, increased underwriting expenses, and legal liability issues that have persuaded subprime lenders to curtail that business or take it to places where no such laws exist. And there has been a reduced willingness on the part of securitizers and aggregators to buy loans originated in covered jurisdictions.

In Georgia, New York, and New Jersey, for example, where particularly stringent anti-predatory laws are in effect, both Fannie Mae and Freddie Mac have drastically reduced or even eliminated altogether their purchase of so-called "high cost" and other real estate loans. And the private investor secondary mortgage market in those states has been hard hit, particularly for subprime mortgages, because of actions taken by the rating agencies in reaction to those states' predatory lending laws. *Moody's*, *Standard and Poor's*, and *Fitch* ratings have all adopted policies that make it difficult, if not impossible, to pool loans originating in Georgia, New York, or New Jersey unless the issuer provides costly credit enhancements and/or certifications that the pool contains no proscribed loans.

This outcome is particularly regrettable because it's unnecessary. We know that it's possible to deal effectively with predatory lending *without* putting impediments in the way of those who provide access to legitimate subprime credit. It's an unnecessary consequence because the approach that's been followed is an across-the-board, one-size-fits-all approach that applies to the good as well as the wrongdoers.

We believe a far more effective approach would be to focus on the abusive practitioners, bringing to bear our formidable enforcement powers where we find abusive practices—after clearly articulating our expectations.

[1] *July 30 Clarification:* The statistics concerning a decline in loan originations for North Carolina borrowers with FICO scores in the 580–660 range mentioned in the Comptroller's speech was based on data presented in tables contained in a study by Quercia, Stegman, and Davis. The OCC has since learned, from discussions with the authors, and the OCC's own continuing analysis of material presented in the paper, that the database from which the tables were derived is more complex and involves variables and uncertainties not apparent from the tables themselves. Based on the OCC's current understanding of the data, it now believes that its initial conclusion regarding a specific percentage decline in originations could not be derived properly from the study's tables and, therefore, was mistaken.

The basic point the Comptroller was making continues to be valid, namely that there is a danger that broad-based laws, however well intentioned, may have an unintended adverse impact on the availability of nonpredatory subprime credit. This view is supported by other studies that provide evidence that subprime lending has declined in states and localities following adoption of predatory lending legislation.

That's exactly the approach we have taken. The OCC has put out the most comprehensive guidance produced by any of the federal banking agencies—and, I suspect, by *any* banking regulator—describing the kinds of abusive or predatory practices that will cause us to take action, making clear what our powers are, and urging all our banks to adopt policies to assure they do not get involved in such practices. In the past, we haven't hesitated to use our enforcement authority to combat unsafe, unsound, unfair, or deceptive practices. Indeed, OCC enforcement actions have resulted in restitution totaling hundreds of millions of dollars to consumers. And, we have served notice that we will continue to do so in the area of predatory lending.

Our guidance makes clear that we expect national banks not only to adopt, but to adhere to policies and procedures designed to prevent predatory lending practices in both direct lending and in transactions involving brokered and purchased loans. We emphasize that it is the bank's responsibility to set standards that address—and avoid—the central characteristics of predatory lending. Each national bank must make the kind of basic underwriting decision we would expect in the case of any loan—namely, that the borrower has the capacity to service and repay the loan without resort to the collateral securing the loan. The guidance also requires national banks to perform adequate due diligence prior to entering into any relationships with loan brokers, third party originators, and the issuers of mortgage-backed securities, to ensure that the bank doesn't do business with companies that fail to employ appropriate safeguards against predatory lending.

It's also essential to recognize that while regulated banks have generally been brought within the scope of these laws, banks are *not* where the real problem exists. A joint Treasury Department-HUD report issued in 2000 found that predatory practices are *least* prevalent among institutions operating under federal oversight. "The subprime mortgage and finance companies that dominate mortgage lending in many low-income and minority communities, while subject to the same consumer protection law, are not subject to as much federal oversight as their prime market counterparts," the report notes. "The absence of such accountability may create an environment where predatory practices flourish because they are unlikely to be detected." In comments submitted in connection with an OTS rulemaking concerning preemption of state lending standards, 46 state attorneys general echoed this view that predatory lending was largely confined to mortgage brokers and finance companies.

A coalition of state attorneys general repeated the same position more recently in a brief filed earlier this year in connection with a challenge to that OTS rulemaking. "Based on consumer complaints received," the AGs stated to a federal court, "as well as investigations and enforcement actions undertaken by attorneys general, predatory lending abuses are largely confined to the subprime mortgage lending market and to nondepository institutions. Almost all of the leading subprime lenders are mortgage companies and finance companies, not banks or direct bank subsidiaries."

From this perspective, then, I think it can be understood why we believe that national bank preemption of the Georgia Fair Lending Act should not be viewed with alarm. The interests of those this law intends to protect are effectively protected—at least as far as national banks are concerned—through our supervisory process. Our approach not only protects consumers where abusive practices are found, it also avoids the over-broad and unintended adverse effects of those one-size-fits-all laws—effects that, as we've seen, can be almost as harmful as the problem those laws were designed to address.

Preemption is a doctrine with almost 200 years of history and constitutional precedent behind it. The OCC didn't invent it; we apply it. In preemption situations, the only relevant issue is whether the state law would impair or interfere with the national bank's exercise of powers granted to it under federal law. If such an impact is found to exist, federal law must prevail—just as it has prevailed for two centuries.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before Women in Housing and Finance, on preemption and the dual banking system, Washington, D.C., September 9, 2003

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In an earlier letter to the OTS, 46 state AGs stated: "In the experience of the state attorneys general, predatory lending is perpetrated primarily by nondepository lenders and mortgage brokers," which "unlike depository institutions, are subject to little regulation by . . . federal agencies."

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In fully half the states, a single bank now accounts for 25 percent or more of the asset base on which the state bank supervisor imposes the assessments needed to fund its office. In New York, one state bank accounts for nearly two-thirds of the assets under state supervision. In Georgia, one bank accounts for 70 percent of assets. In Rhode Island, it's 76 percent.

Needless to say, the loss of a large bank in such a highly concentrated state could have a crippling effect on a state supervisor's ability to provide quality supervision.

These perceptions are reinforced when state supervisors actively proselytize for charters.

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

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

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

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

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

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

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

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the American Bankers Association, on abusive practices and regulation, Waikoloa, Hawaii, September 22, 2003

It's not news to anyone in this room that the banking industry is under attack—once again. State and local legislatures around the country have enacted, or are considering, new laws to regulate various aspects of the business; state law enforcement officials are making dramatic headlines announcing large-dollar settlements; federal regulators are issuing regulations and guidance; consumer activists are leveling broadside barrages; and committees of the Congress are holding hearings and conducting investigations aimed at determining whether new federal laws are needed to curb abusive practices.

So "what's new?" some of you might ask. Banks have always been a favorite target. It's really just a measure of how important the industry is. And, after all, you've learned to live with the burdens of regulation.

Others have a different view. They shake their heads in dismay at the two dozen or more compliance laws passed in the last 30 years—laws that have imposed tremendous burdens on the industry. How many times have you heard a banker friend say that the business "is just not fun any more"? How many times have you cringed just a little bit, or felt you had to apologize, when someone has asked you what your profession is? Believe me: having been a lawyer for over 43 years, I know the feeling.

What's gone wrong? Bankers have traditionally been leading members of the community, and the banking business—a business that, after all, was built on the trust and confidence of customers—was once considered a model of good conduct and rectitude. When I was a new young lawyer the practice of "banking law" largely meant drafting loan agreements and forms. Today, "bank regulatory law" is a major practice area, with law firms competing actively to hire lawyers who know how to guide clients through the shoals of regulations intended to protect consumers by constraining banker misconduct. What has brought this about? Why have banks become everyone's favorite whipping boy? More to the point, what can we do about it?

As one looks back over this period during which the burdens of regulation have become so heavy, there are two circumstances that emerge as common to almost all of the legislative and enforcement activity we have seen: First, they are virtually always responsive to real abuses. Congress generally does not sit around dreaming up ideas for new laws to address hypothetical or speculative problems. On the contrary, it is generally quite unusual for Congress to move quickly on regulatory legislation—the Gramm-Leach-Bliley privacy provisions being a major exception. Most often, they respond only when there is evidence of some persistent abuse in the marketplace over a long period of time.

The second common element is that the abuses that cause legislation are almost always the actions of a very few players, and not pervasive practices in the industry. History could not be more clear: a few bad actors will generally be the cause of burdensome laws that are brought to bear on the activities of the entire industry.

So when we ask what can be done about it, a very natural follow-up question is why has the industry itself failed so profoundly to address the conditions that have given rise to so much regulation? Can't it do better?

Nearly 25 years ago, I wrote an article entitled, "Deregulation and Self-Regulation: Illusion or Reality." It was a time of real pessimism about prospects for thoroughgoing bank deregulation, a pessimism that I generally shared. But if there *was* hope for a new day in banking, I wrote, it seemed to me to hinge on the industry itself doing a better job of addressing its own shortcomings. It also seemed evident to me that the industry's failure to address demonstrated abuses had been responsible for the succession of tough consumer protection laws of the previous decade, such as the Truth-in-Lending and Equal Credit Opportunity acts. But it wasn't too late, I argued, for the industry to take a historic new path toward self-regulation, with all the benefits such a reversal could bring. While I thought it was unrealistic to expect that self-regulation would persuade Congress to repeal existing regulatory laws, I suggested that a good-faith effort by the industry might demonstrate that future regulatory legislation was unnecessary.

There is no question that we have made progress in dismantling some of the more archaic remnants of an earlier regulatory era. Deposit interest rate controls were largely discarded over two decades ago, and we are on the verge of having the prohibition against paying interest-on-demand deposits phased out. But it often seems that for every step or two we take toward regulatory emancipation, we take at least one step back. Banking today continues to operate under multiple layers of regulation that, while undoubtedly providing some protections to consumers, can be extremely burdensome and costly—indeed suffocating—to small banks.

When I addressed the ABA convention last year, I spoke to you about the dramatic changes that were taking place in the country's legal framework for corporate governance. The centerpiece of that change was the Sarbanes–Oxley Act—perhaps the most important piece of corporate reform legislation in our lifetimes. It is significant in the present context, however, that this landmark legislation responded to a relatively small number of highly publicized cases of corporate abuse, virtually none of which directly implicated financial institutions. Indeed, some of its provisions pertaining to the relationship between corporations and their directors duplicated safeguards already in place for financial institutions.

That's not to say that the banking industry hasn't benefited tremendously—and won't continue to benefit well into the future—from the general improvement in public confidence wrought by Sarbanes–Oxley—improvements resulting from greater transparency in corporate balance sheets, more honest and accurate accounting, compensation reforms, and the rest. But along with those benefits come burdens, and the burdens have fallen just as heavily on an industry like banking.

But if banks were only incidentally in the zone of corporate reform legislation, the banking industry *has* been at the center of other key public policy issues—issues such as financial privacy and identity theft, predatory lending, and credit card account management practices. Together, they represent a challenge that may profoundly shape the industry's future. The industry's response to that challenge could go far in determining whether there will be new regulatory mandates in each of those areas, as well as how costly and burdensome those mandates will be. And that, in turn, will have a role in shaping the industry's ability to meet the competition of the financial marketplace and to continue on in service to our nation's economy.

Let's take a look at the issues of privacy and identity theft. The industry's commitment to safeguarding customer confidentiality has long been an article of faith. A 1961 court case declared that:

"It is inconceivable that a bank would at any time consider itself at liberty to disclose the intimate details of its depositors' accounts. Inviolate secrecy is one of the inherent and fundamental precepts of the relationship of the bank and its customers or depositors."

But what was inconceivable in 1961 was hardly unthinkable a few decades later. And those privacy precepts, once inherent and fundamental, came under increasing pressure from technology—which made customer information increasingly available for sale and analysis—and from the competition to diversify, which made consumer information an increasingly precious commodity to an industry that has always been information-based.

Amid growing consumers' concerns about threats to their privacy, most financial institutions recognized the danger to their longstanding reputation for preserving customers' trust. But a few cases of slippage began coming to light. It was headline-making news when one institution was reported to have sold confidential account information to a telemarketer. That revelation led to thousands of depositor complaints, a multi-million dollar cash settlement, and huge embarrassment. The industry was conflicted. Some recognized the need to develop effective privacy standards, but others put a higher value on the need to use customer information to exploit cross-marketing opportunities. Congressional hearings produced stories of the ease with which pretext callers were able to glean account information from careless bank customer service representatives. Many in the industry seemed to believe that privacy was an issue in which consumers would soon lose interest.

But privacy has lost none of its importance to consumers since Gramm–Leach–Bliley was signed into law—quite the opposite. According to Department of Justice statistics, seven million Americans were victims of identity theft last year, making it the nation's fastest-growing financial crime. Some 30 million Americans have already registered with the Federal Trade Commission's National Do Not Call Registry—and I doubt that many of them have a warmer place in their hearts for telemarketing calls that come from banks than from third parties. And, of course, GLBA enabled states to enact tougher privacy standards in some respects, with California poised to do just that.

Although I see some evidence that bankers are beginning to recognize that privacy is, and will remain, a key competitive factor—that consumers will bank where they feel that their privacy is particularly well protected and stop banking where it's not—progress toward self-regulation and standard-setting in the privacy area since GLBA has not been what one would have hoped for.

Let me give one recent example. The federal banking agencies recently came out with proposed guidance for banks setting out procedures they should follow when they have evidence that confidential customer information has been compromised. This is a tough problem. Should a bank notify its customers in every case where there has been a compromise—perhaps causing undue and unnecessary alarm and concern among customers? Or should it wait to see if the confidential information has been misused—in which case it might be too late to avoid irreparable injury to the customer?

Here was a clear opportunity for leaders in the industry to recognize the need for an industry standard or best practice, and to take the lead in addressing this need. To be sure, even responses generated by the industry itself won't always stave off a governmental response, but it's certainly worth the effort. Let me put it in a different way. Would you rather have strong and responsible guidance from your own industry in dealing with an issue of this sort, or a governmental dictate enforceable through bank examiners and cease-and-desist orders? In the absence of the former, you are now faced with the latter.

Let's turn to the case of predatory lending—another of today's most pressing financial public policy concerns. I define predatory lending to mean the aggressive "pushing out" of credit to borrowers who cannot pass the conventional standard of bank underwriting: does the borrower have the capacity to service and repay the loan without recourse to the collateral?

State after state, and city after city, are adopting or considering laws that would subject *all* mortgage lenders, including commercial banks, to significant regulatory restrictions in the name of stamping out predatory lending. Yet, there is no evidence that federally regulated banks—national or state—are a serious part of the problem. Indeed, no fewer than 46 state attorneys general stated that "predatory lending is perpetrated primarily by nondepository lenders and mortgage brokers," which, "unlike depository institutions, are subject to little regulation by . . . federal agencies." And in an *amicus* brief filed recently in connection with litigation over an OTS preemption regulation, 22 state AGs stated flatly that, based on their investigations and enforcement actions, "predatory lending abuses are largely confined to the subprime mortgage lending market and to nondepository institutions," and "not banks or direct bank subsidiaries."

This is no more than you would expect in an industry in which loan officers have been brought up to ask searching questions about a borrower's capacity to repay before extending credit, an industry that is closely supervised by a variety of federal regulators. The truth is that the real perpetrators of predatory lending are neither subject to conventional bank standards *nor* subject to federal oversight. They are for the most part, as the state AGs have said, unscrupulous and unsupervised mortgage brokers and lenders, whose interest is *not* assuring the borrowers' capacity to repay, but to maximize their fees by capturing the borrowers' built-up equity in their homes.

If this is correct, one must ask why the states and cities continue to include banks within the scope of these laws. Surely, there's a political dimension to it. Kicking banks around has been something of a national pastime since the days of Andrew Jackson. That's why it's critically important not only for banks to make legislators aware of where the problem really lies, but to speak out as an industry in condemning those who are guilty of these abusive practices.

There's another reason for banks to speak out. These laws are hurting their legitimate business, and in the process are throwing up barriers to the availability of good, risk-priced credit to creditworthy borrowers who may not have had access to bank credit in the past. We've seen strong evidence that subprime lending has diminished jurisdictions that have adopted such overbroad anti-predatory lending laws—clearly an unintended consequence of these laws. We've also seen evidence that in such jurisdictions the secondary market for subprime loans may have been adversely affected. Fannie Mae and Freddie Mac have severely conditioned their willingness to purchase loans covered by these laws, and some rating agencies have refused to rate securitizations containing loans covered by such laws—thus posing some very real impediments in the national secondary markets. Indeed, after the OCC preempted the Georgia law, Fitch Ratings reversed its earlier decision to suspend ratings of residential mortgage-backed securities containing "high cost" loans originated in Georgia, specifically citing our preemption decision as a justification for its actions. Because it is now willing to rate those securities, additional liquidity is likely to become available in the Georgia mortgage market, with subprime borrowers as important beneficiaries.

As I've suggested, there's much that the industry can do—that it has not done enough of to date—to dissociate itself clearly and emphatically from predatory lending. It can speak with one voice in denouncing such practices, and focus attention on the *real* bad actors. It can renew and reinforce its commitment to financial literacy, it can provide financial counseling to help those who might otherwise become victimized by predatory practices. It can continue to do its part to identify abuses, to develop best practices, and to communicate the results of that effort to the American people. Banks are clearly not part of the problem. They have to demonstrate that they *are* part of the cure.

Is it possible to identify other areas where actual or potential abuses might give rise to the kind of legislation we have seen in the areas of privacy and predatory lending? Let me suggest a couple—credit card practices and "bounce protection" programs.

The United States has the most successful credit card industry of any country in the world, and I am proud to say that the real leaders in this industry are some of our national banks. The development of credit cards has been of enormous benefit to consumers. But unfortunately not all card issuers have the same kind of commitment to high standards that the best players in the industry have. In fact, no retail banking activity generates more consumer complaints—and where there are persistent and serious complaints, there is a fertile seedbed for legislation.

Consider, overline practices. At one time, if a cardholder exceeded his approved credit line, the charge would be rejected at the point of sale. Today, it is common for the card issuer to honor the charge and assess a penalty on the customer for the overline. It is also common, however, for the issuer not to require prompt payment of the overline amount and not to adjust the minimum monthly payment to take account of the overline. Thus, the overline penalty may continue to accrue month after month. One might ask at what point the creditor who has not required prompt repayment of, and has thus acquiesced in, the overline and has de facto increased the line. And if, as a practical matter, the line has been increased, is it unfair or deceptive for the creditor to continue to impose an overline "penalty?" One might also ask whether customers are being given adequate disclosure in situations such as these. At least one state has attempted to address these issues legislatively, and others may well see this area as an appealing one for future legislation.

Similar questions could be raised about some "secured" credit card programs marketed to people with poor credit histories. A common feature of many such programs is that the available credit is virtually exhausted with front-end fees, charges and "security" deposits, leaving the cardholder with no real credit and a sizable account balance. The absence of complete and meaningful disclosure often heightens the abusive nature of these programs.

The industry's leaders in this field should be speaking out on these issues—if not merely to protect customers from the misconduct of a few, then as a matter of enlightened self interest, to avoid getting themselves tarred with the blame.

"Bounce protection" is another accident waiting to happen. Of course, conventional overdraft protection programs have been part of the banking scene for many years. But today, we see some vendors aggressively marketing new programs to banks under which overdraft protection would be affirmatively promoted as a variety of short-term credit, much like the product offered by so-called payday lenders. These programs take a wide variety of forms, and, done right, can clearly serve a very useful need. But there are also opportunities for abuse, and once again there is a danger that the shoddy practices of a few could result in regulatory burdens for everyone.

In this regard, I want to congratulate your incoming chairman, Ken Fergeson, for his statesmanship in identifying this subject as an issue deserving of comment. One of his earliest actions as chairman-elect was to send a letter to all bank CEOs on the subject of bounce protection, cautioning them about the need to treat customers fairly and to provide them with clear, conspicuous disclosures. First and foremost, Ken wrote, consider "how your program will be seen and judged in your community, in the [regulatory] agencies, and in court. He set out a list of steps a bank considering such a program should take to protect itself and its reputation. If you ignore these considerations, he warned, your program "could become your worst enemy."

The most significant thing about Ken's letter was not its substantive advice, which was clearly sound and wise, but the fact that a distinguished banker, in the process of taking over the helm of the industry's largest trade association, took on a leadership role in speaking out forthrightly and frankly on an emerging issue of importance—recognizing that if the issue were to be left unaddressed, there could be unhappy consequences for the industry. This was a significant event, I submit, because of what it implies as a potential role for this great association.

Industry self-regulation, of the sort I pondered in that article 25 years ago, might be unrealistic to expect. But one does not need to embrace full-blown self-regulation to see that there is an important role for the industry to play here. There is no reason why, with enlightened and forthright leadership, the industry could not serve both itself and its customers very well by taking on a more organized role as a promulgator of standards and promoter of best practices. To do so would be a dramatic demonstration that the responsible members of the industry—far and away the largest number of institutions—really care about standards of good conduct and are willing to speak out themselves, rather than wait for draconian governmental remedies.

So here is my challenge to the ABA and its new leadership: Create, either yourselves or jointly with other industry associations, an industry Committee on Banking Standards and Practices, to be composed of a group of the most respected people in the industry. The mission of the committee would be to study, articulate, and promote the adoption of principles of fair dealing and to assemble and disseminate information about best practices. Just as Ken Fergeson set out in his letter a series of cautions for banks considering bounce protection programs, the Committee on Banking Standards and Practices would serve as a forum for addressing issues of importance to the relationship between banks and their customers and as a means for identifying and collecting information on emerging issues.

The committee need not have mandatory enforcement powers or the ability to impose sanctions. Its effectiveness would depend solely on the logic, common sense, practicality, credibility, and moral force of its statements, and on the recognition of its members as individuals of great experience and impeccable reputation. I suspect each of us could identify half a dozen such individuals quite readily. The overriding objective of the committee would be to demonstrate to the public, to regulatory policymakers, and to legislators that the banking industry *is* concerned about standards of conduct and is willing to address the subject in an institutional way.

I am not so naïve as to think that there wouldn't be problems setting up such a committee, and I'm sure each of you has thought of some as I have been speaking. But that is not a reason not to make the effort. Done right—with integrity, thoughtfulness, evenhandedness, and credibility—the establishment of such a group could have tremendous benefits for both banks and their customers. And, if it *is* done right, it could help stem the tide of regulatory measures that has been swamping the industry.

In the final analysis, of course, no standard setter—indeed, no regulatory or enforcement mechanism—can be a fail-safe against misconduct. In any organization, large or small, there will always be the potential for abuse, and that potential will increase in direct proportion to the pressures that lower-level employees feel to romance customers, to take business away from competitors, and to produce profits at any cost. That is the overriding lesson of recent times, when we have seen even some of our best managed companies embroiled in the kind of controversy that not only tarnishes their reputation but impacts their shareholders' interests because of the conduct of a miscreant few. The ultimate protection for all of our banks, and the people responsible for running them, is to instill in *all* employees a dedication to the highest standards of fairness and ethical dealing; to make clear that no loan, no customer, no profit opportunity, is worth compromising those standards for; and to take swift and decisive corrective action where those standards are violated. For an industry whose very survival depends on preserving the confidence, trust, and good will of its customers, no less is required.