

Remarks by
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Most people visit this lovely resort for a break from life's stresses and tribulations. But this is also a place for serious contemplation about the challenges that we face as a society. That's what has brought presidents and heads of state to Pinehurst for many years; it's what brought the North Carolina Bankers Association here for this year's management team conference, and it's what brings me here to join you today.

These are nothing if not challenging times – for our country, facing new and knotty threats from abroad; for our economy, which continues to struggle for positive momentum; and for the banking industry, whose health is inextricably linked to its operating environment – an environment that holds more than the usual brace of challenges.

Challenge is by no means synonymous with crisis, of course, and, indeed, the continued vitality of the U.S. banking system is often cited as a major reason why the national economy continues to hold its own – however precariously -- rather than slipping back into a dreaded “double-dip” recession. Here in North Carolina, for example, the banking system can be characterized as generally stable or improving – much better than one would expect given the recent performance of the state's economy and a significant source of the state economy's underlying strength.

Preliminary second quarter 2002 data for all North Carolina commercial banks show a 10 percent increase in net income, compared to the same period in 2001. Assets are up, though by a

lesser percentage. More than twice as many institutions reported earnings gains over the previous period; the percentage of unprofitable institutions dropped by nearly a third. ROE and ROA were significantly up, as was capital; nonperforming assets were down.

As I've suggested, these performance data are especially noteworthy given the conspicuous, if no doubt transitory, weaknesses in the state's economy – an unemployment rate that has been averaging close to seven percent, above the national average; a slowdown in housing starts; and slow progress in narrowing the gap between the richest and poorest citizens of this great state. The latest Federal Reserve Beige Book pointed to signs of stress in the state's crucial farm economy, and rising vacancy rates in commercial real estate. And that was before the dismal September on Wall Street, which presumably did nothing to bolster the confidence of those in North Carolina responsible for purchasing and hiring.

Not all the challenges confronting North Carolina bankers – and U.S. bankers generally – relate to the current economic uncertainty. Some of those challenges have more to do with secular changes in the business of banking -- changes that were already very much in evidence back in the innocent days when people were convinced that the business cycle had been repealed by the microchip revolution.

The consolidation of commercial banking in this country has been going on for a very long time and for a good many reasons. A certain percentage of the bank mergers of the past decade undoubtedly occurred for no other reason than that it became possible to do them. The Riegle-Neal Act of 1994 tore down the barriers to interstate branching, and bankers with interstate ambitions sometimes sought to achieve them on the quick. Since then, bank mergers have been driven by more fundamental considerations. Bankers have sought to capitalize on

economies of scale, to leverage investments in technology, to diversify geographically, and to broaden product offerings to a more demanding and sophisticated financial consumer.

The results, as you know, have been mixed. While it is certainly true that not all of the promised benefits of this merger activity have materialized for banks, neither have most of the concerns of the critics. As the members of this audience can attest, our financial markets remain highly competitive; our citizens and our communities are, with few exceptions, exceedingly well served by depository institutions; commercial credit has remained widely available, to small businesses and large, on reasonable if not easy terms; employment in the banking industry has not declined appreciably, if at all; and there has been no shortage of new entrants to the banking business, despite the generally inhospitable economic environment.

Yet the structure of U.S. banking has changed in consequential ways, and that change is nowhere more plainly visible than here in North Carolina. Indeed, North Carolina may be the state whose fortunes – and whose very identity as a banking center – are most closely bound up with the trend toward financial consolidation. It's easy to forget how startling it would have seemed just 15 or 20 years ago to suggest that Charlotte would become one of the world's great banking centers. But it has become just that – thanks not only to the legal, economic, and technological developments I've already mentioned, but also to the vision and leadership of larger-than-life North Carolina bankers like Ed Crutchfield, Hugh McColl, and John Medlin, as well as to the equally hardworking but perhaps less heralded North Carolina bankers who lead this organization and those who make up its rank-and-file.

North Carolina's extraordinary rise to national and world prominence as a banking center – and as an economic power – is reflected in numbers that are at odds with national trends. In

only five states of the union are there more commercial banks today than there were in 1984. North Carolina -- which went from 68 in 1984 to 72 today -- is one of them.

Yet when one focuses on the distribution of North Carolina banking assets, the picture comes into closer convergence with national trends. In 1984, the three largest North Carolina banks held 63 percent of total state assets. Today, the three largest control 95 percent. To slice it another way, where the 65 smallest North Carolina banks (out of a universe of 68) shared 37 percent of state banking assets in 1984, the 69 smallest share five percent today. Obviously the pie has grown tremendously over that period, with total assets increasing by about thirty-fold, but that simply highlights the vast dominance – statistically speaking, at least -- of the very largest banking corporations – which, of course, carry on their business not only in North Carolina, but throughout the country.

If you happen to represent one of those big banks, chances are that you take enormous and justifiable pride in those numbers – numbers that affirm everything you have worked to achieve. But what if you're here at Pinehurst representing the Millennia Community Bank of Greenville, with \$24 million in assets -- the smallest commercial bank in the state? What do these numbers mean to you?

The answer may be, much less than one would expect. When we look back years from now, the performance of community banks in the era of banking consolidation will stand as one of the truly inspiring stories of our economic age. Against daunting odds, community bankers have succeeded in keeping their franchises relevant and profitable through judicious adoption of technology, strict controls over operating costs, and a fixed focus on customer service and local responsiveness. You would probably dismiss the suggestion that any of you are heroes, but by

demonstrating that there's a place for individual initiative even on a landscape dominated by giants, heroes are what you are nevertheless.

The consolidation of the banking business has been almost as much of a challenge for bank supervisors as it's been for bankers themselves. It's forced us to modify an approach to bank supervision that has been in place at the OCC – and at the federal and state agencies that have modeled their supervision after ours -- for many decades. That approach was founded on the notion that commercial banks big and small were banks at the core – more alike than different, vulnerable to the same environmental forces and human mistakes. But experience has taught us that banks at either end of the spectrum – and North Carolina is richly endowed with both types -- present very different risks to themselves and to the public interest, and necessitate official oversight of a wholly different nature and degree. The noncomplex procedures we now use for most community banks and the continual onsite presence we maintain at banks in our large bank program reflect this bifurcation. For the OCC, it's involved a totally different way of doing business.

Banking consolidation has also exposed what I believe are serious flaws in the way we fund supervision. I should say, “additional serious flaws,” because I have already expounded at considerable length about the unfairness of a system that requires national banks to bear the full cost of their own supervision and to subsidize a significant portion of the supervision of their state-chartered competitors. The OCC, as you may know, has proposed to deal with that inequity with a plan that would draw upon earnings from the Bank Insurance Fund to offset the costs of all supervision – state and national – and do away with the assessment-based system that was introduced back in the horse-and-buggy days. Such a change would place state and national banks on an equal footing, and end the discriminatory arrangement that delivers benefits to one

favored class of financial institutions and forces national banks --and U.S. taxpayers – to foot the bill. I want to make very clear that our proposal would have significant benefits for state banks, because it would eliminate the need for state supervisors to impose any direct assessments on them.

Fairness aside, perhaps the most damning indictment of our current funding arrangement is that it undermines the very purposes for which it was established: the safety and soundness of all commercial banks and the health of our system of dual chartering options for those same banks.

It seems difficult to defend a funding system that, in times of economic stress, forces supervisors to turn to well-managed banks for the resources supervisors need to deal with problem institutions – another kind of unfair subsidy. But that’s exactly what our current system does with regard to national banks.

It seems difficult to defend a system that has created a marketplace for charters – “bazaar” may be a better term -- in which cost seems to be the principal thing that counts and qualitative factors – such as supervisory philosophy and responsiveness, examination quality, and the scope of permissible activities – are frequently disparaged or disregarded.

In fact, the subsidy renders meaningless any qualitative inferences that might otherwise be drawn from the fee disparity – about the relative efficiency of state and national supervisors, for example – because state assessments reflect only about 22 percent of the total costs of delivering supervision to state banks.

If I’m making widgets and some third party is generous enough to pick up 78 percent of my costs, I can probably afford not to worry too much about my efficiency and still sell my product for a lot less than the competition.

Maybe it's not so remarkable after all that this is a system that still has such vocal defenders.

The main reason why people defend such a system, I gather, despite these grievous and widely acknowledged defects, is that they're afraid that the alternative might be worse. They're afraid, especially, that under any fair and rational system of supervisory funding, some state banks might convert to the national charter, with potentially damaging institutional consequences for state supervisors and their federal counterparts involved in state bank supervision.

Here's where the trend toward industry concentration has cut uncomfortably close to the bone for bank supervisors. It's to be expected that we'd find the largest number of charter conversions among the largest pool of banks. Indeed, between 1990 and 2002, more than 90 percent of stand-alone flips out of the national charter – that is, those that occur in the absence of a merger or acquisition -- involved community banks under \$500 million in assets. Those are the institutions that tend to feel cost-cutting pressures most intensely and that are most likely to be attracted by the prospect of saving a few thousand dollars a year.

For the supervisory agency, the financial impact of such conversions is usually manageable. It can even be a positive if, as is the case at the OCC, the assessment structure is progressive, with community banks generally paying less than the pro rata share of their supervisory costs. Indeed, while we always regret it when a community bank decides to relinquish its national charter, the bank's action can often result in a net gain to our bottom line.

When a bank exceeds a certain size, however, its conversion can be damaging to the supervisory structure, for the departure of a well-managed larger bank may diminish resources that are needed to deal with more troubled institutions. And as large banks grow larger, the potential impact of a conversion gets disproportionately greater.

If that's true for the OCC, with its 2200 national banks -- the largest of which represents 16 percent of the total assets in the national banking system and 10 percent of total OCC assessment revenues -- consider the vulnerability of half of the state banking departments, in which a single state bank accounts for more than 25 percent of the bank assets under state supervision. In eight states -- including North Carolina -- a single state bank accounts for more than 50 percent of the assets under state supervision. In any of those states, the loss of a large bank, to conversion, merger, or failure, could be devastating.

In that light, one can understand why some state supervisors might dig in their heels in opposition to the OCC's proposal to rationalize the supervisory fee structure -- even though our proposal would clearly be beneficial for the banks they supervise. Over the years, a view has taken hold -- a view that I believe is quite erroneous -- that lower assessments are about all that the state charter has to offer, and that if the fee disparity were reduced or eliminated, state banks would flee en masse to the national charter.

But that needn't be the case, and I don't believe it would be. The state bank charter is not in such a state of decrepitude that it needs \$1 billion a year in federal subsidies to shore it up -- and I am surprised that the supervisors of state banks would implicitly take a contrary view.

For much more than a century, against far longer odds than it faces today, state banking has competed successfully through the application of grit, innovation, supervisory responsiveness, and other qualitative attributes that have unfortunately been cheapened in the current obsession with assessments. I am convinced that we can restore fairness of our system of supervisory funding, maintain the vitality of state supervision, and reinvigorate the system of dual chartering that contributed so significantly to the proud and productive history of commercial banking in our country.

Reforming our system of supervisory funding is no panacea. But I believe it's as good place as any to start.