"SMILING THROUGH THE APPOCALYPSE"

REMARKS OF COMMISSIONER JOSEPH A. SMITH, JR.

TO THE NORTH CAROLINA BANKERS ASSOCIATION ANNUAL MEETING

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It is, as always, a pleasure to be with you to discuss topics of mutual interest and concern. This year is an unusually fruitful one for such discussions. I would like to say a few words about the "subprime meltdown," its consequences, and its impact on North Carolina and its banks.

For starters, we should concede that the recent disruptions of and continuing malaise in capital markets are serious, persistent, and potentially devastating. Calculating the losses to the financial system is shooting at a moving target. A recent calculation is that such losses are approaching $400 billion, with estimates of more to come. We have had the near failure of a major dealer in federal securities and recourse to the Fed's discount window by entities other than depository institutions, something unseen since the Great Depression.

But what does this have to do with us, or at least most of us? The crisis has done damage almost exclusively to large U. S. and foreign banks with capital markets operations, thrifts and investment banks. The list of victims includes Citigroup, Washington Mutual, Merrill Lynch, Bear Stearns, and, I regret to say, Bank of America and Wachovia. In addition, there is a substantial list of foreign victims. The recent, and generally welcome, surge of US exports apparently included some really bad mortgage securities.

An innate sense of good sportsmanship would generally prevent me from pointing out that the large majority of the damage to domestic institutions has been felt by large national banks or thrifts. But not this time: it is important to note this aspect of the crisis because of the likely public policy response to it.

The policy debate has already started with the issuance by the U.S. Department of the Treasury of its "Blueprint for a Modernized Financial Regulatory Structure." This paper is admirable in that it addresses a number of policy issues arising out of the recent unpleasantness. It is disturbing, however, in that it applies its prescriptions across the board – one size fits all, Citigroup to Live Oak – and shows no appreciation whatsoever for the benefit conferred on this country by its diverse, competitive and vibrant banking system. Under Treasury's "blueprint" you and I don't exist -- or don't need to.

I believe I know what you are thinking, at least on this topic: we didn't cause this mess and, in any event, the Bush Administration will be history before it can act on the worst of these proposals. As to your first thought, I must tell you that it is correct but not sufficient. The enactment of Gramm-Leach-Bliley and Sarbanes - Oxley make it clear that in Washington, D.C., retribution falls on the just and unjust equally. As to the second, please remember that Gramm-Leach-Bliley was preceded by a white paper from the George H.W. Bush Administration outlining much of what was to come. In our nation's capital ideas, good and bad, have a longer half life than nuclear waste.

What then, are we to do? A few steps that I believe we should take include:

- **<u>Making the Case for a Diverse Banking System</u>**
  The travails of our largest institutions cannot be allowed to obscure the fact that there are over 8,000 banks and savings institutions operating in the United States today that meet the real needs of our nation's citizens, businesses and communities. These institutions – and I'm talking about you – are in the main well capitalized, well managed and focused on providing the financing our state and nation need to grow, particularly to small and medium sized businesses.

- **<u>Advocating for a Two-Tier Regulatory System</u>**
  Given the concentration of banking assets in the United States in general and of capital markets and international exposure in particular, the best policy would be to treat our largest banks and investment banks under one regulatory regime and our community and regional banks under another. This was the original intention of the Fed in its proposed adoption of Basel II and it makes sense. The Treasury White Paper also makes more sense if applied to large banks and investment banks only. Drawing the line between one category and another is a problem, but nowhere near the problem with that of a "one size fits all approach."

- **<u>Broadening the Asset Mix of North Carolina Banks</u>**
  North Carolina banks have significant concentrations of real estate loans. This is not illegal, immoral or fattening in itself, although it does raise supervisory issues. What concerns me more is that the coupling of this concentration with relatively narrow geographic diversity of operations can increase the risk to asset quality and earnings when and if the economy slows. Frankly, we are seeing some of that now. Broadening your asset mix, by loan type or geography, brings its own set of concerns, including regulatory concerns, so I know it's not easy. I'm willing to talk about the topic if you are.

- **<u>Dealing with Issues of Equity and Access</u>**
  In terms of new business, I can't leave you without asking you to give thought to providing enhanced services to low and moderate income folks and to distressed borrowers. I regret to say that in the near term this category of customers will probably grow. I persist in the belief that this part of the market can be profitable, but acknowledge that such business brings with it substantial reputation and possibly regulatory risk and that I bear the burden of proof on profitability. Here again, I am willing to discuss this matter if you are.

I hope you find at least some of these ideas interesting and have others of your own to put on the table. I have already heard from a number of you that raising capital is a very important topic. I believe that if we work together we can establish facilities that can help you get the capital you need and that will augment bank supervision. You will be hearing from me on this. To facilitate our further work together, I am pleased to announce that Thad has graciously agreed to set aside time at the Management Team Conference in October for a discussion of the ideas I have just presented and others you may bring forward. Given the uncertainties that confront us, it is very important that we work together to make North Carolina banking safer, more profitable and more inclusive. I look forward to this work and hope you do too.

Thank you very much.