

**Remarks of Commissioner Joseph A. Smith, Jr.
To North Carolina Bankers Association
CFO Symposium**

Greensboro, North Carolina

August 29, 2007

It is a pleasure to be with you today.

In my days as a bank general counsel, and as Commissioner of Banks today, I have always regarded bank CFOs as my colleagues in assuring that banks tell themselves and their various stakeholders the truth. This is not an easy job and I applaud your efforts to do it professionally and effectively.

I think it would be fair to say that our work together has been and is “rules based;” that is, regulation of banks and the presentation of their financial statements are subject to substantial and fairly detailed statutory, regulatory and GAAP / RAP requirements. Bank managements, and many regulators, complain about it but, truth be told we are comfortable with it. The debate over Bank Secrecy Act, allowance for loan and lease losses, pensions and derivatives may be intense, but the debate is over what the rules should be, not whether there should be rules.

I acknowledge without your mentioning it that Sarbanes – Oxley may be another matter.

This approach to regulation has in recent times been subjected to some powerful criticism. Under the sponsorship of New York City Mayor Michael Bloomberg and U.S. Senator Charles Schumer, McKinsey & Company has published a report on the competitive position of New York and the United States in respect of other international financial centers, particularly London.¹ The report concluded that New York (and the US generally) is in danger of losing its leadership in financial services because, among other things:

our regulatory framework is a thicket of complicated rules, rather than a streamlined set of commonly understood principles, as in the United Kingdom and elsewhere.²

¹ McKinsey & Company, “Sustaining New York’s and the U.S.’ Global Financial Services Leadership,” January 2007 (hereafter, “Bloomberg–Schumer”).

² *Id.* at ii. Bloomberg–Schumer deals with three main concerns, of which regulatory complexity is only one. The other two are (i) the unpredictability of the legal system and (ii) potential loss of skilled foreign-born talent because of our immigration laws. This talk will deal only with the regulatory issue adverted to in the text of this talk.

This view is not isolated to New York City. At a recent conference on capital markets competitiveness, U.S. Treasury Secretary Henry Paulson expressed a concern about the impact of regulation on international competitiveness, pointing out that:

Our regulatory system has served us very well over the course of our history... Yet, the addition of new regulators over many years, and the tendency of these regulators to adapt to the changing market by expanding, as opposed to focusing on the broader objective of regulatory efficiency, is a trend we should examine. We should assess how the current system works and where it can be improved. And we should also consider whether it would be practically possible and beneficial to move toward a more principles-based regulatory scheme.³

Secretary Paulson went on to discuss the need for a review of the accounting industry and the interaction of accountants and corporate managements, suggesting that:

³ Opening Remarks by Treasury Secretary Henry M. Paulson, Jr. at Treasury's Capital Markets Competitiveness Conference, Georgetown University, March 13, 2007.

We should also consider whether our system is producing the high-quality audits and attracting the talented auditors we need, whether there is currently enough competition in the accounting profession, and the desirability of moving toward more principles-based accounting standards.⁴

Clearly, principles-based regulation and accounting is on some intelligent and influential minds.

The critique of U.S. regulatory and accounting standards is that our “rules-based” regime is expensive and cumbersome and that it constricts market participants unnecessarily. This is in contrast, particularly, to London, where financial services enterprises have one regulator – the Financial Services Authority – that is said to regulate financial markets on basis of broad principles rather than a plethora of specific and complex rules. In the same way, international accounting standards are seen as more flexible and less constraining. And, of course, there is no Sarbanes – Oxley in London. The critics are concerned that U.S. constraints on capital markets will increase the amount of financial activity being conducted outside the country, exacerbating a decline that is already in process. Not to put too fine a point on the argument:

⁴ *Ibid.*

savings are growing faster in Asia and the Middle East than it is in the U.S. Deficiencies in our regulatory and accounting practices reduce our attractiveness to foreign pools of capital.

It would be easy enough to ignore the importance of the “principles / rule” debate as inapplicable to most if not all of us in this room. The discussion is really about capital markets in general and the IPO market in particular, which most North Carolina banks aren’t involved with significantly or at all. Further, even a cursory review of the FSA website shows that its broad principles are “augmented” by hundreds (if not thousands) of pages of regulations, interpretations and the like, not to mention the additional requirements of the European Union. We are comfortable with our current practices, warts and all, so let’s put “principles based regulation” in our “flavor of the year” file for 2007, ignore it, and move on.

The “ignore it; it will go away” response to the critique of our rules-based regime is a mistake for a number of reasons:

- Like it or not, North Carolina banks of all sizes are part of a global financial system and are subject to its benefits and demands.

- As seekers of capital in the global markets, North Carolina banks must be as efficient as possible.
- The complex rule driven approach to regulation is expensive and cumbersome and puts our institutions, particularly the smaller ones, at a competitive disadvantage to larger firms generally and internationally active firms in particular.

In my view the discussion of principles-based regulation is really a discussion of the impact of our current system on the competitiveness of our banks. This is a serious issue and we should all treat it as a matter of importance. Let me suggest a few things my colleagues and I are doing in that regard.

First, we have begun a regulatory simplification process for North Carolina banks. We have repealed or revised a number of rules affecting banks that were both cumbersome and outdated. Our next step will be to circulate for comment a totally revised banking law to reflect the realities of the modern marketplace.

The current North Carolina banking law is a good example of a rules-based regulatory statute. The banking law was originally adopted by the General Assembly in 1931. A fine piece of work for its time, it reflected the felt needs in the Depression Era for strong and detailed regulation of banks so that the financial debacle of that time would not be repeated. It has been liberalized since then but, as many of you know, it retains a fairly restrictive approach to bank supervision and bank accounting.

The corporation law has been liberalized in recent times to be more permissive; with the exception of its powers provisions, the banking law has not followed. This state of affairs has not yet affected our banks' competitive position, but I don't want to wait around until it does. A complete revision, to reflect modern circumstances, is in order.

At my request, an *ad hoc* group of lawyers and regulators is preparing a first discussion draft of a revised banking law for general circulation, comment and, I hope, enactment. This group is debating, among other things, how many of the detailed statutory requirements of the current law can and should be replaced by broader standards, with more latitude for interpretation and innovation. A draft should be released no later than the first quarter of next year for public comment and debate.

I hope that bank managements, including CFOs, will participate in the public discussion of this proposal.

How might our revised banking law incorporate principles-base regulation? If it followed the Financial Services Authority, it would incorporate eleven basic principles, requiring each bank to: (1) conduct its business with integrity; (2) conduct its business with due care, skill and diligence; (3) take reasonable care to organize and control its affairs with responsibly with adequate risk management systems; (4) maintain adequate financial resources; (5) observe proper standards of market conduct; (6) treat customers fairly; (7) communicate appropriate information to clients in a clear and fair manner; (8) manage conflicts of interest fairly; (9) take reasonable care to ensure the suitability of its advice to customers entitled to rely on its judgment; (10) adequately protect clients' assets when responsible for them; and (11) deal with regulators in an open and cooperative way.⁵ It would also include a second tier of principals to govern regulatory activity: (1) efficiency and economy; (2) responsibility of senior management of firms for regulatory compliance; (3) proportionality (on a cost / benefit basis); (4) allowance for innovation; (5) consideration of

⁵ Bloomberg-Schumer, *op cit* n. 1, p. 90 (summarizing the FSA basic principles).

international competitiveness; and (6) avoidance of unnecessarily distorting or impeding competition.⁶

The substance of many of the principles I have just mentioned is contained in current banking law and regulations; the issue, as I see it, is whether a revision can improve our banks' efficiency and competitiveness. The keys to success would be (i) the willingness and ability of bank managements and boards to set an appropriate ethical tone from the top; (ii) the willingness and ability of bank boards, managements and regulators to work in a more consultative way; and (iii) the availability of a safe harbor to banks for operating in a new and less regimented environment. This last point is important. Deregulation is associated in many minds with disaster, the savings and loan crisis and recent developments in the mortgage market coming most immediately to mind. What we are talking about is not deregulation but the right-sizing of regulation.

⁶ *Ibid.*

I think a principles based approach to regulation is desirable from the perspective of our banks and their stakeholders. That said, such a regime can only succeed when and if the managements and boards of our banks and their regulators conduct themselves in a way that enhances public confidence in the integrity of North Carolina banking. I believe that we are capable of such conduct and, accordingly, am ready to try further burden reduction and principles-based regulation if the industry is. I hope you are and look forward to working with you to that end.

Thank you very much.