

**BANKING IN NORTH CAROLINA AND BEYOND:
SNAPSHOTS, SPECULATIONS AND PROPOSED
NEXT STEPS**

**Banking Law Institute
University of North Carolina Law School
Charlotte, North Carolina
April 7, 2005**

**Joseph A. Smith, Jr.¹
North Carolina Commissioner of Banks**

¹ The opinions expressed in this note are those of Commissioner Smith personally and do not represent official policy of the State of North Carolina or any agency thereof, including the North Carolina Banking Commission or the Office of the North Carolina Commissioner of Banks.

As always, it is a pleasure to be here in Charlotte at the UNC Law School Banking Institute. As someone who was present near, if not at, the creation of this enterprise, it is wonderful to behold what it has become. I believe that this Institute and the other activities of the Center for Banking and Finance add immeasurably to the intellectual capital of the financial services industry in North Carolina, and trust you agree. My sincere congratulations and thanks to Lissa Broome for her leadership in making the Institute what it is today. We all owe her a profound debt of gratitude.

As I hope you are aware, this is a special year for banking in North Carolina: its 200th anniversary. As Lissa's article in this year's Institute journal notes, two banks – the Bank of Cape Fear and Bank of New Bern – were chartered by the General Assembly in 1804 and commenced operations in 1805. Banking has come a long way since then.

To kick off this year's proceedings, I will discuss where this 200 year journey has taken us. I will present a brief summary of the landscape of the banking industry today, in the United States generally and in North Carolina in particular. I will then discuss the implications of these developments for North Carolina's role as a home state for banks, and will close with a few thoughts about the future.

It is not an undue exaggeration to say that a tectonic shift has occurred in the structure of the U.S. banking industry. Recent mergers, acquisitions and charter conversions have altered the distribution of assets in the dual banking system, substantially increasing the share of such assets held by nationally chartered institutions. This is, of course, only the latest of a series of changes in the financial services industry.

The structure of United States banking has changed dramatically over the last 25 years as the result of changes in regulatory policy and information and communications technology. This has led, among other things, to:

- A reduction in the number of banking organizations overall.
- Significant reduction in number of small community banks.
- Concentration of industry assets in large institutions.
- Likely continued reduction in number of institutions.

A recent development in industry structure is a significant change in the portion of industry assets held by nationally chartered institutions. This has been a relatively sudden occurrence.

For the five years ended December 31, 2003, the share of banking assets in institutions under supervision of OCC, OTS and the states remained relatively constant.

During 2004, a tectonic shift occurred. While the proportion of commercial banks under a state charter increased slightly, from 73.3% to 75.3, assets of state-chartered banks decreased from 44.4% of total commercial bank assets to 41.2%. These computations are for the period ending September 30, 2004. If the J.P. Morgan / Bank One transaction and the acquisition of SouthTrust by Wachovia are included, state-chartered banks account for 32.2% of total commercial bank assets.

Do these developments make a difference to the financial services industry and the public? I believe the answer is yes. A healthy dual banking system has fostered innovation, a diversity of financial services and a healthy diversity of charter options for financial institutions. Limitation of state-chartered banking to small, intra-state enterprises would significantly reduce these important benefits.

Let me hasten to add that increased industry concentration alone is not the end of the world for financial services diversity. A good example of that proposition is North Carolina, which I have been told is an example of what the country could look like if the concentrations trends continue. In the Tar Heel State, seven banking organizations account for approximately 84% of deposits. In addition to the two world class national banks headquartered here in Charlotte, accounting for roughly 56% of deposits, there are five state-chartered institutions, four of which are headquartered here, accounting for an additional 28%. Of the remaining 16% of deposits, state chartered banks hold a predominate share (approximately 13%). The good news on this front from my perspective is that the great majority of our state-chartered banks are well-capitalized and profitable.

For all my happy talk regarding state-chartered banks, the tectonic plates of the national bank system keep grinding. It is too early to tell what the implications of these developments will be for the banking industry generally and for state supervisors and state-chartered institutions in

particular. For proponents of a strong state role in the dual banking system, waiting to see what they are is not an option. We must do some hard thinking to determine what needs to be done to strengthen the state bank charter and then get to work.

Steps to enhance the state bank charter should begin with an understanding that state policy must adapt to reflect changes in the environment in which our institutions operate. These steps include modernization of state banking laws and of state laws regarding interstate banking and branching.

Modernization of State Banking Laws.

There is no model law for banking comparable to the Model Business Corporation Act, so modernization of a banking law is done state-by-state on an *ad hoc* basis. In North Carolina, the Office of Commissioner of Banks and representatives of the industry and banking bar are working on a complete revision of the state's banking laws. Among the issues we are addressing in this revision are:

- How many laws governing banking organizations should we have? At present, North Carolina has separate laws governing state chartered banks, savings banks and savings associations, although there are no real differences in the powers that can be exercised by such institutions, however chartered.
- Should the banking law apply to all banks alike, or should it apply differently to banks based on their size, complexity, lines of business or scope of operations? This is the local manifestation of an issue confronting bank supervisors generally: whether banking is one industry or two or more.
- In what corporate forms should state law allow banks to be organized and operated (corporations, LLCs, other)?
- Should state law define bank capital and, if so, in a manner differently from federal standards?

- Should state safety and soundness standards, particularly the grounds for intervention in bank affairs, differ from federal standards?
- How should state banking law define bank and bank subsidiary powers?
- How should state banking law address electronic commerce?
- Should state law explicitly provide for banks that operate for special purposes rather than in a “full-service” community bank format?
- Should state banking law contain express provisions regarding corporate governance that override or augment state corporation law?

All of these issues, in one way or other, involve the overriding issue of whether state law should conform itself to federal standards or whether there are places where different state standards are necessary or desirable. Many of these issues are also being debated at the federal level.

Facilitation of Interstate Banking and Branching.

State-chartered banks face significant obstacles to their interstate operations, including:

- Restrictions on interstate branching. Twenty-three states currently allow *de novo* interstate branching by banks and 26 states permit interstate branching through one-branch acquisitions in host states. Restrictions on interstate branching, which apply to banks organized under both state and federal law (but not federal thrifts), are a particular problem for small and medium sized institutions that are either unable to grow in markets that cross state lines or are forced into uneconomic acquisitions to do so.
- Enforcement of host state consumer laws. Unlike nationally chartered institutions, state-chartered banks are subject to some host state consumer protection laws regarding their activities and those of their subsidiaries. As a result, state-chartered institutions conducting

consumer activities often have greater compliance issues than do comparable nationally chartered institutions.

Dealing with the interstate commerce issues just mentioned could be addressed by amendments of state laws or possibly by interstate compacts. As anyone who has dealt with these issues knows, there are powerful constituencies that oppose such changes, for good reasons and bad.

Reduction of Regulatory Burden.

State-chartered banks are, of course, subject not only to state law but to a variety of federal laws including, but not limited to, banking and consumer protection laws. Enhancing the state charter could and should involve federal action (i) to reduce regulatory burden, particularly on small and medium-sized banks and (ii) to address interstate issues that the states do not address.

- There is an ongoing effort by the federal banking agencies under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) to reduce or eliminate regulatory requirements that are particularly costly to small institutions and have marginal policy utility.
- A recent and often mentioned regulatory expense of small companies generally and small banks in particular is compliance with Sarbanes-Oxley Act Section 404. Given the attestation requirements under FIRREA to which banks are already subject, I believe there is a policy rationale for relief from SOX 404.
- Congress could resolve the issue of interstate branching for all banking organizations by amendment of the current Riegle-Neal provisions to authorize such activity. A provision of this kind was included in the Regulatory Relief bill that was adopted by the House in the last session of Congress. It stalled in the Senate over issues relating to the branching activities of industrial loan companies (for which read, Wal-Mart).

- Parity for state-chartered banks with national banks in the pre-emption of state consumer protection laws relating to their activities as well as interest rates would enhance the state charter. This reform could be accomplished either through interpretive action of the Federal Deposit Insurance Corporation or through Congressional act that has been called “Riegle / Neal III” by its advocates.
- The Financial Services Roundtable, by a Petition dated December 8, 2004, and modified last month, has sought interpretive action by the FDIC of the kind to which I have just referred. Hearings on the petition are scheduled for the end of May in Washington.

The outcome of all this activity remains to be seen.

Where is the financial services industry heading? It is easy to review the trends I have just discussed and to conclude that the grinding of the tectonic plates is moving us inalterably toward a more highly concentrated industry with a unified set of rules made in Washington. I do not believe this is a desirable result for any of the industry’s stakeholders, including large banks. A far preferable system would be diverse in terms of regulators, institutional size, operating strategy and target markets. In other words: a dual banking system.

It is regrettable, in my opinion, that the ongoing preemption debate has tied the issues of consumer protection and the dual banking system so tightly together. Consumer protection is very important, and it is a responsibility that we in state government take very seriously. But the subject of consumer protection goes far beyond banking and finance.

In my view, a discussion of the dual banking system is a discussion of consumer empowerment: How the banking system should be structured to allow banking organizations to grow and develop to an optimum size and scope – whatever that may be. Removal of artificial impediments to growth – such as interstate branching restrictions – would enhance the ability of both state and national banks to grow as far and as fast as their satisfaction of consumer needs would let them. Such growth would increase competition in

their new markets and would benefit consumers and small businesses. It would enhance efficiency in most, if not all, banks. It would strengthen the dual banking system.

In thinking about the industry's future, I believe that North Carolina's experience has a number of lessons to teach:

- From its beginning, banking in North Carolina was free of undue restrictions on geographic growth. We have had state-wide banking for 200 years. It is often noted that this circumstance prepared our banks well for interstate expansion where permitted. It is less often noted that the competitive environment fostered by this openness required that all banks, to survive, had to be efficient and focused. Competition made banks of all sizes better.
- State-chartered banks in North Carolina have had broad powers, liberally interpreted. Recent pronouncements of the Comptroller of the Currency about bank activities have also expanded the scope of such activities. Some of these pronouncements have actually been supported by the text of the National Bank Act. Both of these examples suggest that the dual banking system functions best when it provides adequate space for experimentation and the development of new products and services.

In summary, strengthening the dual banking system entails the removal of unnecessary obstacles to the optimum development of all banks, state or national. I believe it is fair to say that a number of such obstacles have been removed for national banks recently. Similar liberalization for state-chartered banks is, in my view, in order.

How our banking system develops in the future will depend on a series of factors: growth of our economy, Congressional and regulatory actions, technological change, demographics, and consumer preferences. If we keep before us the complimentary goals of competition, efficiency and consumer welfare, I am confident that the industry's future will be bright.