

Testimony of
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on behalf of the
CONFERENCE OF STATE BANK SUPERVISORS

before the
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

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Good morning, Chairman Shelby, Senator Sarbanes and members of the Committee. I am Kevin Lavender, Commissioner of Financial Institutions for the state of Tennessee, and chairman of the Regulatory Committee of the Conference of State Bank Supervisors (CSBS). Thank you for inviting CSBS to testify on the condition of the state banking system.

CSBS is the professional association of state officials who charter, regulate and supervise the nation's approximately 6,400 state-chartered commercial and savings banks, and nearly 400 state-licensed foreign banking offices nationwide.

CSBS gives state bank supervisors a national forum to coordinate, communicate, advocate and educate on behalf of the state banking system. We especially appreciate this opportunity to discuss the state of our nation's banking system in general, and the state of the state banking system in particular.

Condition of the Industry

As you have heard from my colleagues on this panel, the general health of the banking industry is excellent. State-chartered banks, which make up approximately three-quarters of the nation's commercial banks, have shared in the industry's record levels of prosperity.

Net income of state-chartered commercial and savings banks at year-end 2003 reached \$44.2 billion, an 18 percent increase over the previous year's record levels. State banks' aggregate equity capital ratio stands above nine percent, a level that exceeds the industry aggregate and regulatory requirements, and has

risen steadily over the past three years. State banks' core capital, or leverage ratios, are equally strong, and slightly higher than those of their federally-chartered counterparts. State banks' ratio of nonperforming assets to assets continues to decline, and stands even lower than the industry's overall level.

As regulators, we look for areas of concern, but even some of these areas have shown improvement over the last several quarters. We saw deposits in state-chartered banks grow from year-end 2001 to 2002, and again from year-end 2002 to 2003. And our banks are still finding good loans to make, and we saw strong growth in earning assets in 2003.

We never forget that these record levels of prosperity are occurring in an environment of historically low interest rates, and examiners pay special attention to the vulnerability of our banks' portfolios to interest rate volatility. My colleagues and I have also been particularly concerned about banks' internal controls systems, because experience has shown us that nothing disguises bad management as well as a good economy.

Consolidation of the banking industry continues, raising concern about concentration of risk and the range of meaningful choices available to consumers. The pace of consolidation slowed in 2003, but consolidations continue among the very largest institutions. The nation's 50 largest banks now hold almost 63 percent of banking assets nationwide. In Tennessee, the six largest banks hold more than 50 percent of local banking assets; this percentage jumps to more than 80 percent in Davidson County, the area around Nashville.

We expected consolidation in the wake of the Riegle-Neal Interstate Banking and Branching Efficiency Act. Consolidation has benefited not only the institutions involved, but also customers who live and work in more than one state or metropolitan area. In some cases, though not all, consolidation seems to have led to lower costs for consumers and more convenient access to services.

My colleagues and I worry, however, about declining diversity in our banking system, and about the forces driving this latest round of consolidation. I will discuss these concerns at greater length later in my testimony.

The number of state-chartered banks declined by just over one percent in 2003, compared with a consolidation rate of just over two percent in 2002. A steady stream of new bank charters and conversions has partially offset the number of institutions lost to mergers over the past several years. Of the 117 new banks chartered last year, 100 chose a state charter. This rate – 85 percent -- shows that the banking industry and the business community continue to believe in the value of the state charter. Ten years after the enactment of the Riegle-Neal Interstate Branching Efficiency Act, the state banking system remains a vibrant and essential part of our nation's financial services infrastructure.

State-chartered banks make up just over 74 percent of all commercial banks nationwide. They tend to be smaller than national banks, holding in the aggregate just under 44 percent of U.S. banking assets.

The state system does, however, include several large and complex institutions that operate across state lines. Over the past ten years, state banking departments have worked with the FDIC and the Federal Reserve, as well as other relevant state and federal regulators, to develop a seamless supervisory system that ensures oversight while minimizing supervisory burden. This system continues to evolve.

Our nation's financial system – and our nation's financial services policies – have always emphasized the need for balance, diversity, and opportunity. Americans have traditionally been wary of monolithic authority in any form, whether it's a single oppressive ruler or one gigantic corporation. Chairman Greenspan has noted on many occasions that the diversification of our financial system has been an essential element in preventing the kind of lingering crises we have seen in Asia and Europe. Our state banking system encourages entrepreneurship in the banking industry, creating opportunities for new credit providers to enter the market and find new ways to serve their communities.

As we have seen time and time again, however, not only in the banking industry but also in the business world at large, even the most entrepreneurial environment needs oversight, especially when public confidence is at stake.

The state banking departments supervise and regulate a wide range of financial businesses in addition to commercial banks and savings banks. Most state banking departments, including my own, supervise state-chartered credit unions as well as thousands of nondepository financial businesses.

The Tennessee Department of Financial Institutions, for example, licenses and supervises 749 industrial loan and thrift offices, 63 insurance premium finance companies, 1,287 mortgage companies, 390 check cashers, 1,196 deferred presentment services companies (“payday lenders”), and 42 money transmitters, as well as 159 state-chartered banks, 10 trust companies, two Business Investment Development Companies, and 129 state-chartered credit unions.

Our mission is to provide the citizens of Tennessee with a sound system of state-chartered financial institutions. We do this by monitoring compliance with the state laws and regulations that promote sound business practices and safeguard depositors and consumers. We conduct onsite examinations not only of our depository institutions, but also of our nondepository licensees. An entire division of our department was recently formed and is dedicated to consumer resources; in fact, the department resolved 500 complaints in 2003.

Senators, state banks in Tennessee and nationwide are healthy. The state banking system, however, faces a grave threat, and I ask your help in restoring the balance that makes it possible for my department to fulfill its mission.

Role of Preemption in Maintaining the Health of the Banking System

The balance between federal and state authority over banking activities, and between large and small institutions in the marketplace, continues to evolve. If nearly 140 years of history have shown us anything, it is that the health of the American banking system depends on competition and meaningful choice: the

availability of a wide range of options for both consumers and financial institutions.

The Conference of State Bank Supervisors is committed to maintaining the competition and choice that have characterized our dual banking system. Competition and choice in our banking system remain strong despite the industry's consolidation, and the availability of the state charter is crucial to this balance. The largest institutions can and should grow to serve their customers and reach new competitive levels in a global market. As big institutions become even bigger, *de novo* chartering – again, primarily at the state level -- continues to guarantee local banking options to all consumers. Even in this global economy, it remains true that one size does not fit all.

A key element of this dynamic balance is the question of federal preemption of state authority. My colleagues and I believe that federal preemption can be appropriate, even necessary, when genuinely required for consumer protection and competitive opportunity.

Few matters of federal preemption meet this high standard. One that does is the permanent extension of the amendments to the Fair Credit Reporting Act, which we congratulate you on enacting last year. The CSBS board of directors determined that these amendments served the national interest, and we applaud the careful consideration that both houses gave that legislation.

Many state banking departments and other state agencies have consumer protection mandates that they take just as seriously as their federal counterparts

do. As Securities and Exchange Commission Chairman William Donaldson has noted, federal authorities "cannot be everywhere." Our state-level consumer protection initiatives serve the public interest in their own right, but also complement federal law enforcement efforts in a very important way.

Many of the nondepository financial businesses my office licenses have some affiliation with a larger, deposit-taking financial institution. In the wake of the Comptroller of the Currency's recently-promulgated rules that preempt Tennessee authority over operating subsidiaries of national banks, these businesses have a powerful incentive to change their corporate structure for no reason other than to escape state oversight.

The Comptroller of the Currency's recent regulations preempt almost all state laws that apply to these businesses, if they are operating subsidiaries of national banks. This regulation also tries to shield all national banks – and their operating subsidiaries – from oversight, inspection and enforcement actions by any state authority, including the state attorneys general.

The Comptroller has said repeatedly that these new regulations present no fundamental shift in the OCC's roles or responsibilities. He has called these regulations merely the next logical step in the OCC's interpretation of the National Bank Act, the Riegle-Neal Interstate Banking and Branching Efficiency Act, and Gramm-Leach-Bliley. The Comptroller has also said that these changes are incremental in nature and unlikely to have major effects on the banking industry or on consumers' experiences with financial institutions.

These claims are simply not true. These regulations are not minor or incremental changes. Their scope is nearly unlimited, and their implications are potentially enormous. These regulations exceed the OCC's statutory authority and disregard Congressional intent. They effectively discard the oversight and consumer protection structure already in place for these businesses, and they ignore Congress's design for functional regulation.

The OCC adopted these regulations over the strong objections of CSBS, the National Governors Association, the National Conference of State Legislatures and all fifty state attorneys general. The OCC also ignored requests from members of Congress for extra time to consider their implications. Instead, the OCC issued a set of regulations that will affect millions of consumers across the country without a public hearing and without meaningful consultation with the parties these regulations would affect. We object strongly to the OCC's process in issuing these regulations, and we look forward to the findings of the General Accounting Office's study of this process.

Technology is changing the delivery of financial products. Many large banks and some small banks look less like the old commercial bank and more like the diversified financial services providers envisioned by the Gramm-Leach-Bliley Act. We appreciate that the largest financial services providers want more coordinated regulation that helps them create a nationwide financial marketplace. These goals are understandable. The state of Tennessee and CSBS support coordinated regulation in order to promote modernization of financial services,

healthy competition among providers, and greater availability of financial services to the public.

The OCC's new regulations, however, usurp the powers of the Congress, stifle states' efforts to protect their citizens, and threaten not only the dual banking system but also public confidence in our financial services industry. They challenge the functional regulatory structure created by Gramm-Leach-Bliley and set the Office of the Comptroller of the Currency as the nation's dominant regulator of financial institutions. They also seem to encourage consolidation among our largest institutions, concentrating financial risk in a handful of gigantic institutions that may become – if they are not already – not only too big to fail, but also too big to supervise effectively.

Importance of Decentralized Supervision

Maintaining a local role in consumer protection and a strong state banking system is more important than ever in the wake of the current round of mergers among our nation's largest financial institutions. These mergers make economic sense for the institutions involved, and may offer the customers of these institutions a larger menu of products and services at prices that reflect economies of scale. But the strength of our banking system is its diversity – the fact that we have enough financial institutions, of enough different sizes and specialties, to meet the needs of the world's most diverse economy. Centralizing authority or

financial power in one agency, or in a small group of narrowly-regulated institutions, would threaten the dynamic nature of our economy.

State supervision and regulation are essential to our decentralized system. State bank examiners are often the first to identify and address economic problems, including cases of consumer abuse. We are the first responders to almost any problem in the financial system, from downturns in local industry or real estate markets to the emergence of scams that prey on senior citizens. We can and do respond to these problems much more quickly than the federal government.

The Comptroller has argued that the laws and rules states have enacted to protect their citizens are burdensome to national banks. We are sensitive to regulatory burden, and constantly look for ways to simplify and streamline compliance. Your own efforts in this area, Senator Shelby, have greatly reduced unnecessary regulatory burden on financial institutions regardless of their charter. The industry's record earnings levels suggest that whatever regulatory burdens remain, they are not interfering with banks' ability to do business profitably.

Dual Banking System and History of Preemption

The dual banking system is part of our democratic heritage. The phrase "dual banking" refers not only to the parallel systems of state and federal banking regulation, but also to the interaction of state and federal laws for the benefit of our national and local economies. Since the creation of our dual banking system in 1864, all banks, regardless of their charter, have been subject to a combination

of federal and state laws. The balance of state and federal authority has evolved, shaped by new state and federal statutes and by a growing body of case law.

The ten years since the passage of Riegle-Neal have transformed the financial services industry, and in this transformation we have seen the value and strength of our dual banking system. Many believed that nationwide banking would mean the end of the state regulatory system -- that the states would become irrelevant or be unwilling to compromise in order to supervise multi-state institutions. Instead, the state banking system is now stronger, in many ways, than it was ten years ago. Interstate branching and financial modernization have compelled all of us at the state level to answer the hardest questions: What is the purpose of state supervision? What do we need to do to protect our citizens, and what have we been doing just because “we always did it that way”? How can we leverage the resources of other agencies to improve our own performance and reduce regulatory burden? What authority do we truly need, and what’s just a battle over turf?

Senators, these are issues that all regulators struggle with daily. Because so many powers originated at the state level, because the states were the first to pass interstate branching laws, and because Congress let the states control the phase-in to interstate branching, we have developed models for inter-agency information sharing, cooperation and coordination that benefit the entire financial services industry.

Many, even most, of the new federal powers under Riegle-Neal and Gramm-Leach-Bliley originated at the state level. Over the past ten years, however, we have seen a new aspect of the dual banking system's value. As new products and services have emerged, so too have new opportunities for consumer confusion and, in some cases, abuse. The explosion of the mortgage industry created a new class of lenders for nonprime borrowers, and in some cases, these lenders engaged in predatory and fraudulent practices. Many states sought remedies through enforcement of existing state laws, new legislation, and financial education campaigns. Our efforts have reached thousands of borrowers and potential borrowers, punished and discouraged predatory lenders, and brought a national spotlight to this problem.

Our experience in this area shows that the dual banking system is not a museum artifact, but a vital and essential dynamic for promoting new financial services while offering new approaches for consumer protection.

Ten years after the passage of nationwide banking, the dual banking system is more important than ever. It ensures diversity in our financial services system, and it ensures that the regulatory system addresses local concerns as well as national concerns. In this case, that specifically means the interests of local borrowers and consumers.

The traditional dynamic of the dual banking system has been that the states experiment with new products and services that Congress later enacts on a nationwide basis. We generally discuss this history in terms of expanded powers,

but the states have been innovators in the area of consumer protection, as well. States enacted CRA and fair lending statutes before the federal government did, and states are now leading the way on predatory lending, identity theft, regulation of overdraft protection products, and privacy initiatives. These state laws, which the OCC sees as burdensome to national banks, are in fact providing all of us the opportunity to see what works and what doesn't, and find the appropriate balance before seeking legislation on a national level.

Conclusion

Our highly diverse financial system is the envy of the world. American markets are flexible and responsive, and American banks are competitive globally as well as locally, in large part because of our decentralized regulatory system.

We believe that our dual banking system acknowledges the needs of multistate banks and financial services firms while protecting consumers. We have worked hard, within the state system and with our counterparts at the federal banking agencies, to develop a system of supervision that allows for innovation while ensuring safety, soundness and economic stability. The strong condition of our 6,400 state-chartered banks and 400 state-regulated offices of foreign banks is the best evidence of our success.

CSBS looks forward to working with the Congress to find additional ways to address the needs of an evolving nationwide financial services system in a way that maintains this strong condition, minimizes unnecessary regulatory burden,

and ensures that all Americans retain their access to the broadest possible range of financial opportunity.

We thank you for this opportunity to testify, and look forward to any questions you and the members of the Committee might have.