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NORTH CAROLINA COMMISSIONER OF BANKS

JOINT COMMITTEE TO STUDY THE
MODERNIZATION OF THE NORTH CAROLINA BANKING LAW

NORTH CAROLINA GENERAL ASSEMBLY

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Chairman Brubaker and members of the Committee, I am Joseph A. Smith, Jr., North Carolina Commissioner of Banks. Thank you very much for holding this hearing and for inviting me to speak to you. With your permission, I will review the current status of banking in North Carolina, summarize the history of our banking law, propose some changes to it and introduce a draft of a proposed law that includes these changes.

I would first like to discuss with you the reasons for revising our banking law. This is not a new topic. In an address at my swearing in for my first full term as Commissioner, in August 2003, I set forth as one of my goals:

> Modernization of North Carolina's banking laws and our bank supervisory activities to ensure that North Carolina banking organizations have all of the tools necessary to compete effectively in a financial services marketplace that is now global in scope and driven by technology.[1]

That statement is as relevant today as it was over nine years ago. What's taken so long to get to revision? As members of this Committee will soon see, revision of a statute like the banking law is not an easy job; it is time-consuming and detailed work. In the past, banking law revision for all of the relevant stakeholders – banks, regulators, consumers, communities, advocates – was a desirable goal, but not immediately necessary. The existing law, liberally interpreted, served the needs of the industry and the public interest reasonably well. I respectfully submit to you that revision is necessary today.

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[1] Available at: http://www.nccob.gov/Public/docs/News/Testimony%20And%20Speeches/Archives/CommissionerSwearingIn_speech.pdf.

What has changed? As I will discuss later in this presentation: almost everything. The banking industry, along with the rest of our economy, took a severe hit in the financial crisis of 2008. The health of the economy and the banking industry have declined as a result and recovery is slow. The structure of the industry is becoming ever more concentrated. The regulatory landscape continues to change with an increasing Federal role and attendant complexity. The industry's need for new capital is great and growing. Public trust in the banking industry and its regulators has been weakened.

It would be easy enough in this state of affairs to do nothing, blaming "the banks" for our current economic malaise and letting events take their course. The easy path in this instance would not be the right one. The banks that are supervised by the North Carolina Office of the Commissioner of Banks ("OCOB") are community and regional banks, two of which I acknowledge to be in the super-regional or mega-regional category. None of these banks engaged in the conduct that brought on the financial crisis; rather, they are "main street banks" whose business models are centered on small and medium sized businesses, local communities and their residents. Reform of our banking laws can reduce the burden of regulatory compliance for these banks and facilitate their raising of capital, so that they can more effectively meet the needs of our citizens. In addition, revision of the statute can help preserve the role of this state in regulating our financial system.

Background

In order to put the proposed revision of our banking laws in context, I will review the current status of the banking industry in the United States generally and in North Carolina in particular. I will then review the history of banking in North Carolina and the State's supervision of that industry.

The United States

The United States has a dual banking system, comprising:

- National banks, organized under the National Bank Act and supervised by the Office of the Comptroller of the Currency ("OCC"). Bank of America, Wells Fargo, Community One, and The First National Bank of Shelby are national banks with headquarters or significant operations in North Carolina.

- Federal savings associations, organized under the Home Owners Loan Act and supervised by OCC.

- State-chartered banks and thrifts, organized under state law and supervised by state bank supervisory agencies – in North Carolina, OCOB – together with either the Board of Governors of the Federal Reserve acting through regional reserve banks (the "Federal Reserve") or the Federal Deposit Insurance Corporation ("FDIC"). BB&T, First Citizens, and 79 other community and regional banks and thrifts are state-chartered institutions with headquarters in North Carolina. A list of state-chartered institutions is attached as Exhibit A.

National banks and thrifts account for 27% of the number of banking institutions in the United States and 70% of total industry assets. State-chartered banks and thrifts account for 73% of institutions and 30% of assets. Most of the systemically significant banks in our financial system are national banks. The largest of these banks have capital markets operations and account for a significant share of the credit card and mortgage markets.

Our financial services marketplace also includes credit unions, mutually-owned organizations based on a "common bond" among members. Credit unions are organized and regulated under both federal and state law. If added to banking institutions and assets, credit unions would account for 38% of total institutions and 9.6% of total assets.

Banking organizations are supervised to ensure their safe and sound operation by the governmental agencies referred to above. In addition, banks are subject to extensive consumer protection regulation, including:

- Federal consumer protection laws and regulations under such laws issued by federal regulatory agencies. The Consumer Financial Protection Bureau ("CFPB") created by the Dodd-Frank Wall Street Reform and Financial Protection Act ("Dodd-Frank") is now responsible for regulations under these laws.

- Examination and enforcement to ensure compliance with Federal consumer protection laws and regulations by:

    - The CFPB, in the case of banking organizations larger than $10 billion in assets.
    - The OCC, Federal Reserve or FDIC, in the case of all other banks.

- The Federal Community Reinvestment Act ("CRA"), which requires that banks meet the credit needs of communities from which they receive deposits, including low and moderate income communities.

- CRA examinations by each bank's primary federal regulator.

- State consumer protection laws; in North Carolina's case, interest rate limitations under Chapter 24 of the General Statutes and our Unfair and Deceptive Trade Practices Act. These laws are included in state bank examinations and are enforceable, as a rule, by state attorneys general.

I believe it is fair to say that banks are heavily regulated. While no bank likes the extent of current regulation, the cost of compliance is particularly heavy for small banks.

The United States banking industry is highly concentrated. The top five banks in the United States account for 53% of total industry assets and are equal to 57% of Gross Domestic Product, a vast increase in concentration from past norms. For what it's worth, concentration is worse in the UK, Switzerland, Ireland and Iceland. In a number of cases, including our own, this concentration has resulted in bank difficulties affecting the entire economy, resulting in taxpayer exposure.

North Carolina

North Carolina is served by 128 banking organizations. Banking in our state is more concentrated than the United States as a whole, with the top five banks accounting for 81% of total deposits and 49% of offices. The top ten banks account for 87% of deposits and 63% of offices. Unlike the total US market, three of the five and six of the ten largest banks operating here are North Carolina state-chartered banks. Overall, North Carolina state-chartered banks and thrifts hold 31.4% of total deposits in the State and operate 56% of all offices. These figures are as of June 30, 2011, and will be changed during the next year by the acquisition of RBC Bank (USA) by PNC, a national bank headquartered in Pittsburgh, Pennsylvania, and of Bank of Granite by Community One, a national bank headquartered in Asheboro.

It is also important to note that banking is not an entirely local activity. Out-of-state banks do business here and our banks operate in other states. As of June 30, 28 out-of-state banks held 19% of total North Carolina deposits and operated 32% of bank offices in North Carolina. Conversely, the top ten North Carolina state-chartered banks have operations outside North Carolina, accounting for 60% of their total deposits. While this percentage will be reduced by the merger of RBC into PNC, it will increase by subsequent acquisitions and interstate branching by our banks.

Since the financial crisis of 2008, banking in North Carolina has gone through a difficult period. Wachovia, an institution with deep roots in this State, was acquired by Wells Fargo in that year. Twenty-nine of our state-chartered banks received federal investments under the so-called "TARP" program. Five of these banks have paid back the TARP investments; 21 have not; and three have refinanced the investment. Seven of our banks sought and received $99.2 million of

federal capital investments through the Federal Small Business Loan Fund, $73.9 million of which was used to refinance TARP investments. We have had four bank failures since 2008, two in Wilmington, and two in Western North Carolina. We currently have 15 banks that are subject to consent orders mainly attributable to loan losses and related depletion of capital. Our community and regional banks have, in the aggregate, non-performing loans, charge-offs and OREO at high levels relative to historic norms and in comparison with some other states. These problems can only be resolved by restructuring the loans, if possible; collecting the loans, including taking possession of collateral; and disposing of the collateral, often real estate. In the current environment, these actions usually result in losses to the bank. Such losses can cause the bank itself to be rendered insolvent – witness our recent failures – unless the bank has sufficient balance sheet strength to absorb them. This, in turn, requires capital.

Capital is a technical term among banks and bank regulators that will be addressed as this Committee goes through the proposed revisions to the banking law. For present purposes, I believe it is sufficient to say that capital represents the net worth of a bank: what is left over after liabilities are subtracted from assets. The two main sources of capital are retained earnings – profits that are not distributed to shareholders – and new investment in the bank's common or preferred stock. For many of our banks, earnings have been small or non-existent in recent times, so capital has had to be sought from other sources: the government (through TARP and SBLF) or private investors.

North Carolina state-chartered banks have had some success in raising capital. Since 2008, our banks have raised a net investment of $392 million from TARP and SBLF and $337 million from investors, mainly private equity firms. North Carolina banks on average have a higher level of capital than banks throughout the Southeast or the nation generally. That said, there is a continuing need by our banks to attract capital both to address the balance sheet problems discussed above and to finance growth.

A second challenge for our community and small regional banks is to broaden and expand their business models to generate the preferred source of capital: earnings. Many of our banks have relied too heavily on their local real estate markets. This source of loans will, in all probability, be smaller in the future, so these banks will need new sources of earning assets.

How We Got Here: A Brief and Selective Review of the History of North Carolina Banking

When discussing banking law, Professor Lissa Broome of UNC Law School often quotes Justice Holmes: "a page of history is worth a volume of logic."[2] This is true with regard to North

[2] *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921).

Carolina's banking law in particular. The history of our banking law makes clear that banking is not like other businesses. It has always been conducted under governmental authorization that has reflected both its importance to the public good and a desire by government to ensure that banks and bankers operate in a safe and sound manner, consistent with the public interest.

Ironically, perhaps, North Carolina was the last of the original 13 states to charter a privately owned bank.[3] In 1804, the General Assembly chartered two banks: the Bank of Cape Fear and the Bank of New Bern. These banks opened for business in 1805: Bank of Cape Fear in Wilmington, with a branch office in Fayetteville, and the Bank of New Bern in New Bern only. The charters were for a term of years and were renewable at the discretion of the General Assembly. It is interesting to note that the State of North Carolina was a minority investor in each of these banks and the majority investor in a third bank chartered by the General Assembly in 1811: the State Bank of North Carolina. It was the intention of the General Assembly that there should be no further bank charters in North Carolina other than in these three banks and accordingly, in 1814, the General Assembly authorized these banks to open branches wherever they wished in the State.[4] This is the origin of statewide branching for North Carolina, which is often mentioned as the basis for the expansion of our banks in the 20th Century.

The national bank charter was created in 1863. National banks issued national bank notes, a uniform federal currency. Congress imposed a tax on state bank notes and hoped that state banks would avoid the tax by converting to a national charter. Instead, state banks discontinued the use of state bank notes and pioneered the use of deposit credit transferable by draft or check – the modern day checking account. During the Civil War, North Carolina state banks were required to transfer their gold and silver reserves to the Confederate States of America (CSA) in return for interest-bearing notes from the CSA. At the end of the war, the Union elected not to honor the CSA notes and all state banks were forced into liquidation. The first new banks to open thereafter in North Carolina were national banks. State bank charters were soon also granted, beginning with the Bank of Greensboro in 1869.

The power to charter banks in North Carolina was retained by the General Assembly until the enactment of a general banking law in 1903.[5] Regulation of banks was overseen by the General Assembly, which required banks to make reports to the State Treasurer. In 1889, the General Assembly appointed the first bank examiner, and in 1891, required the examiner to report to the State Treasurer.[6] In 1899, the General Assembly created the Corporation Commission, which was given the powers formerly exercised by the State Treasurer related to banking, including

[3] Broome, "The First Hundred Years of Banking in North Carolina," 9 N.C. Banking Institute 103 (2005). In this article, Professor Broome acknowledges and relies on T. Harry Gattton, "Banking in North Carolina: A Narrative History" (1987).
[4] *Ibid, p. 111.*
[5] *Ibid, p. 127.*
[6] *Ibid, p. 126.*

examination.[7] In 1921, the General Assembly adopted legislation creating a Banking Department within the Corporation Commission and establishing the office of Chief Examiner.[8] In 1927, jurisdiction over the liquidation of banks was removed from court-appointed receivers and granted to the supervisor of banks in the Corporation Commission.[9] In 1931, the General Assembly adopted legislation creating the Office of the Commissioner of Banks, a State Banking Department, and an Advisory Commission made up of the State Treasurer, State Attorney General and three other members appointed by the Governor.[10] In 1939, the General Assembly replaced the Advisory Commission with a State Banking Commission.[11] Mr. Gurney P. Hood of Wayne County was the first Commissioner of Banks, serving from 1931 to 1951. I have the honor to be the 11th person to hold that office.

Over the years since 1931, additional responsibilities have been assigned to OCOB with regard to regulation and supervision of other financial services providers. In 2001, the Savings Institution Division of the Department of Commerce, which regulated state-chartered savings banks and savings and loan associations, was merged into OCOB, and the Commission was expanded to reflect that new responsibility. A number of non-bank financial services providers have been made subject to the jurisdiction of the Commission and OCOB over time: consumer finance companies in 1961; money transmitters in 1963; refund anticipation loan facilitators in 1989; reverse mortgage lenders in 1991; check cashers in 1997; mortgage bankers and brokers in 1998; mortgage loan originators in 2002; and mortgage servicers in 2009. In addition, the Commissioner has the authority to extend one time the allowable filing date for any foreclosure proceeding on a primary residence for a period of up to 30 days and, in certain circumstances, additional time under legislation originally adopted by the General Assembly in 2008.

In addition to state law, North Carolina state-chartered banks are subject to federal supervision and regulation. The nature and extent of this regulation, both in terms of bank safety and soundness and consumer protection have increased over the years. North Carolina state-chartered banks are supervised jointly by OCOB and either (i) the Federal Reserve, if they are member banks under the Federal Reserve Act; or (ii) the FDIC if they are non-member banks. All North Carolina banks are subject to the FDIC's regulations regarding federal deposit insurance. Examinations and supervision are carried out under standards established by the federal bank regulatory agencies, supplemented by standards of OCOB relating to state law. Of particular importance in this process is the application of capital adequacy measurement under the "prompt corrective action" standards established under the Federal Deposit Insurance Corporation Improvements Act of 1991 ("FIDICIA"). As the result of FIDICIA, these standards

[7] *Ibid, p. 127.*
[8] Batton, *op. cit. n. 1 at p. 75.*
[9] *Ibid, p. 76.*
[10] *Ibid, p. 79.*
[11] *Ibid, p. 80.*

are the basis on which much of current bank regulation rests and the FDIC is predominant in enforcement of them and in the resolution of banks that fail to meet them.

A substantial portion of the state law that currently applies to North Carolina banks – Articles 1 through 14 of Chapter 53 of the General Statutes – has its source in the actions of the General Assembly from 1921 through 1931. Additional provisions of Chapter 53 – Articles 17, 17B and 18 – relate to interstate banking and branching, the authority of banks headquartered in North Carolina to carry on operations in other states and for out-of-state banks to operate here. For all of the 19th Century and well into the 20th Century, it was not legally possible for banks from one state to branch into other states or acquire banks in other states. These barriers were weakened by the interstate compacts of the 1980's and the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 ("Riegle-Neal"), which resulted in industry consolidation that saw a number of North Carolina Banks grow dramatically. The Dodd-Frank Act of 2010 removed any remaining obstacles to interstate banking and branching.

As the result of changes in federal law regulating banks, North Carolina's banking law is out of date. It contains a number of provisions that are at once more restrictive than those contained in federal law and less effective. In addition, North Carolina banking law is much more restrictive than the Business Corporation Act, which was itself revised over twenty years ago. This has led bank managements to avoid the burden of the banking law by forming holding companies under the Business Corporation Act or other more liberal corporation law of another state. It is time to revise the banking law.

A Proposed Revision of the North Carolina Banking Law

Because of my view that a revision of the banking law has become not only desirable but necessary, I convened a small working group comprising the counsel to the North Carolina Bankers Association and the law firm that represents it, the senior leadership of OCOB and our counsel and completed the proposed revision that I have submitted to you. It is the result of hours of discussion and debate regarding the needs of the industry, of the OCOB and of the public. After this work, I did a final review and editing of the draft. After the final edits, the proposal was circulated to representatives of stakeholders in the industry: the bar association, bank counsel, consumer advocates, academics. OCOB has set up a website for disclosure to the general public of information about the proposal.

The draft is presented as a whole text, rather than as proposed revisions to the current law in order to make it easier for those who review it to do so without undue complication. Anyone who has tried to determine how the Dodd-Frank Act has changed current federal law will know what I am talking about. Unlike the corporation law, there is no model act to which you or I can refer, nor is there any other state effort of which I am aware to do what this proposal attempts to

do. As you will see, the draft changes current law by revising a number of provisions to reflect the developments I have been discussing and reorganizing the text in a way that makes it easier to use, in a number of cases by moving existing provisions to new locations in the text. It is proposed that some outmoded provision of current law simply be dropped. All of these changes will be reviewed with you in detail in future meetings of this committee.

The proposed revision is organized as follows:

Article 1 contains provisions regarding the statute's scope and applicability and a definitions section applicable to the entire statute. This Article replaces Article 1 of current law, N.C.G.S. § 53-1. The proposed definitions provision – § 53C-1-4 – makes a number of material changes and additions, including:

- Replacement of definitions that reflect the accounting and supervisory capital restrictions of the current law (*e.g.*, surplus, undivided profits, unimpaired capital fund) with definitions relating to capital adequacy that reflect the "prompt corrective action" categories that are the real and effective measures under current law.

- Adding provisions relating to a bank's capitalization that are consistent with the Business Corporation Act.

- Including definitions that describe the various banking organizations affected by the statute and their federal and state supervisory and regulatory agencies.

- Adding definitions that reflect the inclusion of interstate banking in the law itself, rather than separate statutes.

The changes and additions are extensive and will be reviewed with you in full at a future meeting.

Article 2 of the proposal deals with the Commission and the Commissioner. It replaces portions of Article 8 of the current law, specifically N.C.G.S. §§ 53-92 – 53-99.1, that provide for the establishment of the Banking Commission and the Office of the Commissioner, governance of the Commission, operation of the OCOB and official records, including confidentiality of such records. The proposal also includes provisions regarding rule-making and administrative hearings. The following features of proposed Article 2 should be noted as a preliminary matter:

- The structure and governance of the Commission and Commissioner, which have served this State well for eighty years, remain intact.

- The proposal seeks to establish rule-making, hearing and official records provisions that are applicable to all of the statutes administered by the Commission and the Commissioner, not just the banking law.

- Provisions of the current Article 8 that deal with bank supervisory activities have been moved to Article 8 of the proposed statute.

Article 3 of the proposal contains the provisions governing the organization of a new bank. It replaces Article 2 of the current statute, N.C.G.S. §§ 53-2 – 53-17. The proposal attempts to simplify and clarify the role of the Commission and the Commissioner in the organization of new banks but does not, in my view, materially change the process or impede organization of banks. I expect a significant amount of comment from the banking bar on this Article nonetheless.

Article 4 of the proposal contains provisions regarding the governance of banks. The Article replaces Article 5 – N.C.G.S. §§ 53-39 – 53-42.1 – and Article 7 – N.C.G.S. §§ 53-78 – 53-91.3 – of current law. In general, proposed Article 4 continues the relatively broad governance approach of current law rather than adding state requirements to the growing body of federal law. Changes of note include:

- Repeal of the provision of current law that authorizes assessment of shareholders of banks whose capital is impaired. N.C.G.S. § 53-42.

- Proposed § 53C-4-5 liberalizes the director qualification requirements of current law by removing residency and investment requirements. The appointment and conduct of directors remain subject to both state and federal regulation, and directors are required to submit to service of process in Wake County. This change is proposed to remove potential obstacles to the raising of capital by our banks and to the appointment of directors who may be able to contribute to the bank but who do not have financial resources available to make meaningful initial investments.

- Proposed § 53C-4-10 adds a new provision to the banking law that makes a review of board composition, structure and conduct a factor in OCOB examinations of the bank and its management.

Article 5 of the proposal contains provisions regarding bank powers and investments, including investments in subsidiaries. The proposed Article replaces Article 6 of current law, N.C.G.S. §§ 53-43 – 53-77.3. The proposal carries forward the liberal provisions of existing law and attempts to conform them to federal law, particularly the Gramm-Leach-Bliley Act.

Article 6 of the proposal deals with bank operations. It covers a number of subjects currently governed by existing law, including:

- *Lending restrictions; loans to one customer*. This provision has been amended to conform to the requirements of Section 611 of the Dodd-Frank Act, which provides that an insured state bank may participate in derivatives transactions only if the state where that bank is chartered has, as a part of its law on lending limits, a provision that requires that credit exposure to derivative transactions be taken into effect in applying these lending limits. This matter is so important to our banks that I will be submitting to you a provision amending current § 53-48 to the same effect.

- *Accounts.* The proposal contains provisions regarding bank accounts, replacing current Article 12, N.C.G.S. §§ 53-146 – 53-147. The proposal carries forward the General Assembly's recent revision of the provision on payable on death accounts.

- *Branching*. The proposal seeks to cover both branching by banks, North Carolina and out-of-state banks, within North Carolina and interstate. It also replaces the concept of a "limited service facility" with that of a "non-branch bank business office." These provisions replace N.C.G.S. § 53-62 and Articles 17 and 17B.

Article 7 of the proposal covers mergers, acquisitions and other control transactions. It is intended to replace current N.C.G.S. §§ 53-12 – 53-17.2 and to incorporate provisions regarding interstate transactions currently contained in Articles 17, 17B and 18 of Chapter 53.

Article 8 of the proposal authorizes the supervision of North Carolina banks by the Commissioner and OCOB. It replaces portions of Article 8 and all of Articles 9 and 10 of the current law. The proposal carries forward many provisions of prior law, updating supervisory enforcement powers to apply the proposed new capital provisions.

Article 9 of the proposal authorizes voluntary liquidations of banks and involuntary liquidation by the Commissioner in cases of distressed banks. It replaces Articles 3 and 4 and part of Article 13 of current law. This Article carries forward in concept the provisions of current law and updates them.

Article 10 of the proposal authorizes supervision of bank holding companies. It is intended to replace Article 18 of current law.

Unfinished Business

The proposed revision of the banking law does not revise or repeal Article 11 (Industrial Banks) or 18A (International Banking) of the current law, nor does it revise Chapters 54B (Savings and Loan Associations) or 54C (Savings Banks). This is because revision of the basic banking law is a heavy enough lift and these other statutes are either sufficient for their present use (Chapters 54B and 54C), little used (Article 18A) or unused (Article 11). These statutes can be the subject of further legislative action if the General Assembly wishes to take them up.

Summary

Banking is important to North Carolina. Our State has always been a leader in banking, based in large part on the actions of the General Assembly. The current proposal is submitted to you with the intention of continuing that leadership. I greatly appreciate your willingness to take up this matter and look forward to providing you with such assistance as you may require in your work. I would be happy to respond to any questions you may have and thank you for your attention.