



## FINANCIAL SERVICES

# Resource Regulation: The Road to Relevance

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Keynote Remarks of Christopher C. Gallagher  
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The Information Age and its modern communications technology have compressed our nation into an entity that cries out for the efficiencies and economies of scale offered by a single, central regulatory system. The future of our dual regulation system is clearly in question.

Congressional activity to provide total preemption is already underway with the so-called Ney bill. In response perhaps, the OTS has laid down its comprehensive preemption marker, and we all know that, absent Congressional tinkering with OCC authority, the OCC's continued aggressive approach to preemption will be hard to resist. This is not to say that taking a stand, as Connecticut has in the Wachovia case, is unwise. It is to say, however, that you are not only dealing with a very competent adversary—just ask the insurance industry—in this new age, you may be building sand walls in the face of an incoming tide.

Moreover, despite its constant praise of states' rights and devolution, this Administration is a big business administration. Big business operates nationwide with scale economies. And when it comes down to efficiencies, cost savings and scale versus the slogans of the far right, efficiency usually wins, no matter what the political rhetoric. Certainly centralized federal bank regulation isn't going away.

And if it isn't the top-down reach of the OTS and OCC, the states' attorneys general are pushing in from the side, grasping public attention while they move into your jurisdictional territory. But more on that later.

So...what about state bank regulation? Should banking's dual regulatory system continue? Should banks in a post-Enron age be allowed to play off one regulator against another? Can multi-state enterprise be efficiently, or even safely, regulated by the proverbial "patchwork" of individual state regulators? Can the less-than-bountiful resources of our states stand up to the legal, political and financial firepower of national and worldwide enterprise? These are relevant questions. For you all to stay relevant, you need to ask—and answer—each of them.

There has always been a pendulum swinging between government and markets in our mixed economy. What I want to talk about today is the present position of that pendulum, the new trends towards deregulation, and the opportunity state bank regulators have now, to do it right—an opportunity that may be their last.

I believe the answer to the questions I have raised is yes—but only if state bank regulators regulate better—not with "me too" pile-ons, making state regulation more stringent, or by going softer, which is not an option either, because enforcement-type regulation is on the rise and will continue to increase. Moreover, the recent pressure for "federal floor" legislation pushing state legislatures to be more stringent is unlikely to abate in any case.

My remarks today are meant to be thought-provoking and helpful as you contemplate your relevance to the future of financial services. I am a banking attorney. It may seem strange to you that I believe that relevance—your relevance—must be realized—that you as regulators have a critical role to play in the survival and success of banking—especially community banking—and that the Information Age is your friend, not your enemy—but I most definitely do. Here's why.

### **First, the big picture....**

The Blackout of 2003 was a powerful reminder that the 20th Century's "triumph" of markets over government proclaimed by the tub-thumpers of free markets is not quite complete. Even the *Wall Street Journal* recently front-paged a David Wessel think-piece entitled, "Visible Hands. A Lesson From the Blackout," noting that, "Free Markets Need Rules." As Wessel put it, markets need "adult supervision." The fact is, reregulation, not deregulation, is the order of the day. The number of those who blindly trust the "invisible hand of the marketplace" to manage markets in a manner that will enhance the wellbeing of the majority is shrinking. Ideological market purists are offended by these recent developments. They fear that any concession to governmental supervision will surely result in reestablishing the over-rigid regulation the world rejected only a few years ago.

Recent trends are clear. Recent months have provided numerous examples of free market abuse and reregulatory response. So, you needn't look too far to find examples of behavior proving that "adult supervision" of government is still much-needed in America today. But if our mixed economic and political system combining capitalism and democracy is to survive the backlash of an angry public, effective Reregulation is more critical now than ever.

To limit the likelihood of more Tycos, Arthur Andersons, MCI-Worldcoms, Enrons, blackouts and other regulatory breakdowns, we need to get it right, and quickly. Markets without transparency, reliability and oversight are commercially counterproductive. No one will use them. The right kind of regulation is the kind that lets sunshine in rather than shading it with arcane complexity; the right kind of regulation is sensitive to public concern; the right kind of regulation is tailored to the scale and capacity of the regulated; and in the future, the right kind of regulation will better utilize the new technologies to the maximum. The challenge you face is to be there when it happens. The opportunity is to lead the charge. Right now the feds are out in front.

So far this year, the SEC and the NYSE have responded to stock market abuses with reforms in accounting practices and reporting.

The FERC is pressing for regional grid operations that are both independent of the utilities that comprise it and can curtail the chaos of uncontrolled competition.

The FCC has reached for greater consolidation of media ownership only to be slapped down by Congress, and the courts.

The FTC's Do Not Call Registry has become the most popular list in America. House, Senate and Administration response to the courts has been instant and overwhelming.

These regulatory measures all are federal—that doesn't make them right—but they are responsive. Why can't the states do the same; why not lead the way?

### **And what about banking itself?**

Although the recent outbreak of abuses included a few bankers, notably Citicorp, J.P. Morgan and Bank of America, so far, banking has managed to avoid the public's wrath. Ascribe that, if you wish, to good behavior. I expect, however, that conduct driven by the decade-old and much-maligned regulatory enforcement twins, FIRREA and FDICIA, had more to do with it. Thus far, banking gets a reasonably clean bill of health because bank regulators were already on the job.

So...where is banking regulation in the new era? What is called for now? And what can states do?

Some say we must move from strict safety and soundness regulation towards more consumer protection regulation. OK—but in my view financial service regulation does not stray far from safety and soundness regulation when it focuses on "consumer protection." Safety and soundness and good consumer service are in my view one and the same. Why?—because reputation risk is now critical. Banking as we know it cannot survive the loss of the public trust. Neither can bank regulators. So when bankers, blind to the shifting ebb and flow of public concern, choose to play fast and loose with that trust, bank regulators cannot afford to stand idly by. Like the few bad apples that can spoil a barrel, the conduct of a few bad bankers can quickly burn up the public trust that fuels the industry, and protects its competitive niche in this new environment. Reputational damage is viral. Loss of the public's trust is fatal. Therefore, state regulation—indeed all banking regulation—must enhance and ensure the public's trust.

So go ahead—use reputation risk to expand your oversight, but don't just add on new regulations. Consumer protection is not necessarily achieved by piling on more rules. People need financial resources. As you all know, too much regulation can erect barriers that can cut them off. Accordingly, effective regulation must also protect and promote the survival and success of the regulated. Too many regulations is as damaging as too few. They may protect you from criticism, but they can keep the job from getting done. Prune where you can.

Too often, bankers are focused only upon their bottom line and their own customers. They ignore the consumer. Bankers are not prone to notice general trends. Eager for greater "wallet share," they continually probe their customers, looking for ways to serve them better. Given their relentless inattention to customers in the old days (when banks were a franchise protected from meaningful competition by necessity and convenience laws), such customer focus is progress, but attention limited solely to customers is too short-sighted for success in today's regulatory and competitive environment.

Similarly, bank regulators too often rivet their focus on the complex systems they police. By temperament, habit, and yes—by overwork—they are often drawn into the arcane vortex of their craft, losing sight of the broader competitive world in which their regulated enterprises must succeed. But if regulators lose sight of broader trends and public concerns, the public, especially the political public, will look elsewhere for protection. They will bypass the regulators, going straight to Congress, the Courts or state legislatures. We all have seen this happen time and time again. Public concern about privacy, predatory lending, and unfair and deceitful practices has drawn others into the fray with rigid legislative directives that can be counterproductive and dangerous. Then bank regulators wind up playing "catch up."

And while state attorneys general may appear to be well-intentioned, financial service regulators should be enforcing your laws, not attorneys general or class action attorneys—and just as a cautionary aside, beware of your allies in responding to federal preemption. If the public perceives any gaps in the mantle of protection presumably provided by bank regulators, state attorneys general will gladly fill them—whether that is out of concern for the public or for the public's concern for them doesn't really matter. If you are viewed as not doing your job, someone else will. And any jurisdiction lost in this fast-paced world will not easily be regained.

My point is this. Bankers focused on their business cannot be counted on to listen effectively to the general public. You, their regulators, must do so—actively—not just to avoid adverse Congressional and legislative action, but to get it right. Failure to do so leads inevitably to the wrong kind of reregulation by the wrong people, the kind that is over-rigid, or that otherwise fails to take into account the needs of the banking business.

"Bank regulators do it better." (Sounds like a bumper sticker.) But they do—because they know the business better, they can watch and adjust through the intensity and the flexibility of the examination process. Most important, they appropriately view consumer protection as a part of safety and soundness, but because it is, regulators must also preserve the solvency, survival and success of the enterprises they regulate. They have to keep their charges alive and well, as well as keep them honest. And that makes all the difference.

So when I hear bankers objecting to overreaching regulators' "inventing" terms like "reputational risk," I always note that we want to be regulated by folks who need us to win, who want us to be successful, and who understand our business better than folks who are in the business of getting reelected. That is also why when I hear state regulators complain about federal bank regulator over-reach, I always ask, "Was there a gap"? To borrow an analogy from football, OTS and OCC will take whatever the defense gives them. You are the defense. Do we want Congress or state AG's to regulate banks? Whom do we want to regulate banks?—Don't give them the room to move by leaving conduct unregulated that ought to be.

In short, although it may sound strange coming from a bank lawyer, I am urging you to listen to the public, act before others who would take away your authority act, and be aggressive in preserving your role as the exclusive referee of banking conduct. Learn from the OTC. State chartered banks remain state chartered because they like state regulation. But state regulation itself will survive only if it remains as relevant to the public and to the community it regulates. And it can be relevant, BUT ONLY if it is viewed by the public AND BY BANKERS as a resource, not just a source of more rules. Being a resource involves much more than the wooden application of restraints.

The model is "parent"—not "policeman." Cooperative compliance needn't imply complicity, conspiracy or capitulation. Discipline without support doesn't cut it. You need your charges, your banks, to be functionally independent and strong. Guidance is just as important as conformity.

The state banking regulatory community has arrived at the scene too late in many key areas.

Take privacy for example. The privacy fairness principles of notice, choice, access and security had been kicking around for more than 25 years before Gramm-Leach-Bliley. Alan Westin at Columbia had been carefully keeping track of the expanding number of privacy hawks or fundamentalists. The Internet's arrival, with its spam and ease of informational transmission and access, was bound to further spook the public as it eased the sale of social security numbers, moving identity theft from the localized business of dumpster diving to the thriving industry it is today. The trend was clear—consumers were about to become outraged. Bankers missed it. They said—"My customers have no problem with privacy."

Anyone who has spent more than two hours in the field of banking policy is aware of what I am about to say.

As it is with Congress and Congresspeople—it is with banks. Everyone likes their own bank, but dislikes banks in general.

So what a given bank's customers think about it is not what moves the wrong kind of reregulation, especially reregulation by folks whose job depends on reelection.

Bankers needed guidance from their regulators.

Predatory lending is another example. In an information age, where data can not only be sliced and diced but assembled, aggregated, and manipulated, certain bankers became predatory. How long did they think they could get away with bilking the public before class actions and legislation would follow? How did everyone else get into the act? Why are banking regulators only recently getting around to acting?

Unfair and deceitful practices is another key area. How long before banks are no longer exempted from state mini-FTC laws, leaving attorneys general to enforce them against banks, while paving the way for more class actions? State regulators cannot afford to stand by, waiting for permission to act. If reputation risk is about trust, you have the power to move now. If consumer protection IS safety and soundness, you have all you need to act. Upholding standards of fair dealing in the regulated industry is a traditional dimension of the regulatory assignment that needs constant refreshment.

BUT, beyond compliance and guidance, flexibility, creativity and thoughtful response are the keys to preserving the state's valuable role.

Don't just mirror the feds with, "Me too." Get out in front with an active supervisory attitude that will keep informed consumers happy and regulated banks strong.

Active, engaged supervision, not just passive, slavish imposition of rigid rules. REGULATION AS A RESOURCE IS THE ROAD TO RELEVANCE. Responsive regulation is especially critical for community banks who lack the size and scale to keep abreast of social trends. They need your support—you need them to survive and succeed.

In addition to heightening your attention to public concerns and reflecting those concerns in your emphasis, I believe you also need to become more granular in your regulation style. By that I mean you should use the knowledge, flexibility and now, the availability of precise data to regulate each bank according to its own blend of CAMEL elements and its own risk. You are increasingly equipped by the same technology that contracted this country into a single market. You can now customize your regulatory approach to each bank. If banks can pursue a customer "market of one," you also can regulate banks according to their own individual characteristics, using the "real time" precision the technology now offers. Just as community banks can now use the technology to compete with the big guys, you can use it to do a better job than the feds, the Congress, or states' attorneys general.

The answer to predatory lending concerns is clearly not the imposition of more or rigid regulatory burden on the subprime market that strangles it and cuts all credit to those who need it most. The answer is to price lending pursuant to the risk involved, a process that, thanks to the new technology, is becoming more a science than an art.

Like any fungus, unfair and deceitful practices cannot withstand the light of day that will shine on them because of the technology. Eventually the market will do its job. New intermediaries like LendingTree.com will weed out the bad guys far more quickly than state and federal regulation. The next swing of the market to government pendulum we will be back toward freer markets, newly liberated by information and communication technologies that actually empower the consumer to protect himself.

And while federal regulators are issuing nationwide edicts, as though one size fits all, you can use your proximity and flexibility to be the new relevant regulator—a resource who, like a parent, does best when setting boundaries and watching carefully, and dealing responsively and responsibly with your charges individually as they are. Sell this model to your state chartered banking community and you will remain relevant forever.

**Here's how state banking regulators can be a resource.**

*I. You can stay alert to social trends beyond banking that affect it—*

Privacy  
Internet activity  
Customer relations manager

Trends are critical to survival in a competitive arena—their survival and yours.

When Elliot Spitzer becomes the public's protector of consumers of financial services, you may no longer be needed.

You should be thinking of expanding what you regulate, not just defending it. Folks who thought they sold window blinds are now in the window treatment business, or they are out of business. If you just regulate banks and not the rest of financial services, you are slated for extinction.

*II. You must fully utilize the new technologies yourself.*

Regulation in real time is not only possible, it is necessary. It will save money, time and regulatory burden while it keeps you and the banks on the curve, if not ahead of it.

*III. New capacity to analyze data means that risk can be better assessed and understood.*

Real time regulation will reduce your risk as regulators, which in turn will enable you to be more flexible. Underlying standards to protect the consumer are fine. Standards to shelter incumbents from creative competition, or to make regulation easy are not.

Information technology has led to centralization of regulation, but centralization is only an early step on the way to more granular, customized regulation.

*IV. Last, and certainly not least, is the very real problem posed by state budget wars and convergence resulting in a shrinking universe of fewer institutions, who in turn must each pay a greater share of supervisory assessment.*

In a recent speech on this very subject, no less than Jerry Hawke himself offered his "sympathy" for the precarious capacity of state bank supervision in an era of budget deficits and increased asset concentration that has "in fully half the states, a single bank accounting for 25 percent or more of the bank supervisors asset base for funding assessment."

Today, you are in position to take advantage of a brief convergence between the old world, where geography and physical proximity actually meant something, and the new, connected world of information technology. Time is short. You need to begin now.

So think of regulation as a dual responsibility, both to the public and to the regulated. Protect the public, but be a resource to the regulated community. Despite your so-called "regulatory culture," that might seem to militate against the kind of entrepreneurial spirit needed to succeed at this—succeed you must. Bean counters are made, not born.

If you can become a resource and can convince these banks you regulate that you have done so, you will stay relevant forever. More important, you will have helped to save our community banks, who need your help to preserve their continued relevance. I believe that community banks will always be a fundamental pillar of this nation's economy. Regulate as a resource and you and, most importantly, the community banks who desperately need your guidance through resource-based regulation, can both survive and succeed. Thank you.

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