

THE FINANCIAL CONSTITUTION: PAST, PRESENT AND FUTURE

**Address delivered at the
Thacher Proffitt & Wood Conference
Financial Services 2006**

New York, New York

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May 4, 2006

It is a pleasure to be with you today to renew old friendships and to discuss matters of mutual interest and concern.

I would like to talk with you today about America's financial constitution: its development, its current makeup and the challenges it faces. This topic may seem a little "liberal artsy" for you. Please stay with me for a few moments; the implications of what I have to say are profoundly practical.

My discussion is based, at least in concept, on Professor Philip Bobbitt's brilliant book, *The Shield of Achilles*.¹ In this book, Professor Bobbitt analyzes the interrelationship of war, constitutional doctrine and history in the development of the modern state. Bobbitt argues that states are born and developed through conflict on the battlefield and in the related competition between forms of government, as reflected in history. The modern state has gone through a number of transformations, leading to the establishment and development of what Professor Bobbitt calls the "nation-state" in the 19th and 20th Centuries and the "market-state" today. As these two forms of the state are relevant to my discussion, I will spend a moment on them.

Bobbitt defines the nation-state as the form of the state where the governmental apparatus (the "state") is in service of its people (the "nation"). Two examples of the formation of nation states are the United States as reconstituted during and after the Civil War and Bismark's formation of modern Germany. In each case, conflict created a state formed to serve the nation that resulted from the conflict.

The Twentieth Century was in substantial part the story of what Bobbitt calls the "Long War" -- starting with World War I and ending with the fall of the Berlin Wall -- waged to determine the predominant form of the nation-state: liberal parliamentarianism, fascism or communism. Along with the violent conflicts involved in the Long War, there was a contest for constitutional legitimacy, based on a determination of which form of nation-state best provided for the welfare of its citizens. As I hope we can all agree, the good guys won that one.

The triumph of the liberal parliamentary nation-state is not, regrettably, the "end of history." Rather that constitutional settlement is now being tested by revolutionary developments in information science, telecommunications and weapons of mass destruction. These developments are eroding the effectiveness, and thus the legitimacy, of the nation-state and are giving rise to a differently constituted state, the "market-state." According to Professor Bobbitt, the market-state,

depends on the international capital markets and, to a lesser degree, on the modern multinational business network to create stability in the world economy... Its institutions are less representative (though in some ways more democratic) than the nation-state ... Like the nation-state, the market-state assesses its economic success or failure by its society's ability to secure more and better goods and services, but in contrast to the nation-state it does not see the State as more than a minimal provider or redistributor.

¹ Philip Bobbitt, *The Shield of Achilles: War, Peace and the Course of History*, (Anchor Books 2003).

Whereas the nation-state justified itself as an instrument to serve the welfare of the people (the nation), the market-state exists to maximize the opportunities enjoyed by all members of society.²

While I will grant to skeptics of this theory the fact that it is a theory, I would invite you to consider for a moment how well it describes current trends in our lives. Take Social Security – please! I hope that we can agree, at least for purposes of discussion, that constitutions of various kinds are established through conflict and rest ultimately on the legitimacy conferred by public acceptance and support, as determined by history.

The analysis I have just summarized applies to the financial services marketplace in two ways that are relevant to our discussion. First, the development of the modern financial services marketplace has played a significant role in the transformation of the nation-state to the market-state. Second, the financial services marketplace itself has a constitution – which I will refer to as the “financial constitution” -- that has been formed out of conflict and which is itself subject to tests of its legitimacy over time. I propose to discuss each of these themes in the remainder of these remarks. Because the topic is potentially a vast one, I will focus my remarks on the financial constitution as it affects the “retail” market: services to individuals and small businesses.

As a prelude, I should first point out that the formation of the American nation-state during and after the Civil War included the creation of a national financial system. An important part of Mr. Lincoln’s program to form a “more perfect union” was the National Bank Act, which created a system of national banks and a national currency intended to bind the nation together and to encourage commerce. It is not an exaggeration to say that this project succeeded and that the nation is a stronger one as a result. As an additional bit of good news in this regard, the national system of banking has included and does include separately constituted state banking systems that comprise a still vibrant part of this county’s dual banking system.

The development of the national banking system after the adoption of the National Bank Act has itself been characterized by an epochal war of sorts conducted in the courts and in Congress. The conflicts in the courts have involved the assertion by the states of power to restrict the operation of national banks within their borders and by the banks of the right to operate with minimal interference from any governments other than the national government. The conflicts in Congress have been waged by banks, primarily national banks, to break down state restrictions on interstate operations and to authorize uniform national practices, particularly with regard to various aspects of consumer finance.

In general, the national banks have won the long war I have just described. Barriers to interstate banking have been substantially dismantled and attempts by states to regulate the conduct of national banks have been denied. Through a brilliant and aggressive campaign led by the Office of the Comptroller of the Currency, an expanding interpretation of the business of banking and the exclusiveness of the OCC’s jurisdiction to determine its parameters and govern its practices have been upheld by the federal courts. Among the few issues remaining to be determined are whether archaic state restrictions on interstate branching by national and state

² *Ibid*, 229 (*emphasis added*).

banks will continue to pertain and to what extent state banks will obtain the same benefits as national banks in interstate commerce.

So far, so good, I expect, for most of you. Before you get too comfortable, I must tell you that the financial constitution which I have partially described is, like its political counterpart, being tested by a number of forces that challenge its preeminence, if not its legitimacy, and that may lead to further conflict and a different settlement. These challenges are essentially the same as those confronting the political state: revolutionary changes in information technology and telecommunications and, instead of weapons of mass destruction, financial terrorism. How might these threats affect the financial constitution?

In the first place, it is clear that the test of legitimacy of the financial constitution will be the test of a market-state: whether it maximizes the financial opportunities of all members of society. This should not be a surprise, as the modern financial system was in the vanguard of the weakening of the role of the nation-state. In his analysis of the market-state, Professor Bobbitt quotes Mr. Walter Wriston to interesting effect with regard to state control of finance. Referring to national control of monetary and fiscal policy, Mr. Wriston describes a radical shift of power to what he calls an “information standard”:

Unlike [prior standards], the information standard is in place, operating, will never go away and has substantially changed the world ... bad monetary and fiscal policies anywhere in the world are reflected in minutes on the Reuters screens of the trading rooms of the world. Money only goes where it's wanted, and only stays where it's well treated, and once you tie the world together with telecommunications and information, the ball game is over ... For the first time in history the politicians of the world can't stop it.³

While the statement just quoted is almost twenty years old, it is relevant today because of the implications of its themes: the provision of public goods is essentially controlled by capital markets, acts of political states to attempt to control or undermine markets will drive capital away and, as a result, will deny financial opportunity to the citizens that politicians are attempting to help. These themes are at the center of the continuing debate over a variety of issues in consumer finance regulation today: predatory lending laws, payday lending, and credit card terms, to name only a few. The debate has shifted from the shape of our national financial system to the impact of global capital markets on the state, financial institutions and consumers of financial services. The test of legitimacy of the market-based financial constitution that is being formed through this debate is whether it maximizes the financial opportunities of all members of our society.

What is the current state of our financial constitution and what are the challenges it faces? With regard to the financing of commerce, it is pretty clear that capital markets dominate a large and increasing portion of the sector through the activities of investment banks and the capital markets operation of our largest commercial banks. Recent surveys show that community banks have retained a significant share of the small business market, but that even this market is being

³ *Ibid*, 221, referring to statements of Mr. Wriston quoted in Jeffrey A. Friden, *Banking on the World: The Politics of International Finance* (Harper & Row, 1987), 114-115.

served increasingly by large firms.⁴ While this increase in competition would seem to be a good thing for small business, the good news is marred by some evidence that bank acquisitions have resulted in a decrease in business lending in the markets of the acquired firm.⁵

With regard to the consumer market, capital markets have swept the field. The residential mortgage market, an activity that was traditionally conducted by local institutions set up to achieve the national purpose of home ownership, has been “deconstructed” and is capital markets driven. The same can be said for credit cards and other features of consumer finance. There can be little doubt that this development has greatly increased the availability of credit to consumers. As I will discuss later, it can be debated whether the dominance of capital markets has resulted in maximum opportunity for every member of society.

What lies ahead for our financial constitution? It depends upon the interplay between the state and financial institutions as they address challenges to their legitimacy: the external threat of terrorism and the fundamental question of whether our financial system delivers the goods for the citizens of the market-state. On the first of these challenges there is substantial agreement; on the second, there will be continuing controversy.

For purposes of this discussion, “terrorism” includes all attacks on the financial system by persons or enterprises hostile to it and its intended purpose. Terrorism certainly includes politically and nihilistically motivated attacks intended to bring the system down: computer viruses and physical attacks on the system’s infrastructure come to mind. It also includes identity theft, credit card and mortgage fraud, and that low-tech classic, bank robbery. Each of the activities I have just mentioned attack the legitimacy of the financial system by attacking its promise to its stakeholders to handle financial transactions in a manner that is safe, sound and confidential. With these forms of terrorism there can be no compromise. Make no mistake about it: we are at war with the bad guys and there is no substitute for victory.

I acknowledge what many in this room are undoubtedly thinking: the campaign against terrorist finance and money laundering is cumbersome, not demonstrably effective, and unfair in that it seeks to deputize private institutions for purposes of law enforcement. I have two answers to these concerns. First: you’re right. Second: that’s the way it is; get over it. While I and many of my colleagues in government are sympathetic to your concerns, none of us can seriously argue for dilution of AML / BSA efforts. I would argue that the same is true for the leaders of financial institutions. The good news on this front is that the governmental agencies with a stake in enforcement are working together constantly to coordinate their efforts and to reduce regulatory burden. The financial services industry has an important part to play in this process and I hope that the industry will continue to be engaged with government in a way that will result in AML / BSA efforts that are only as burdensome as they need to be and no more.

A form of “terrorism” that is growing and pervasive these days is mortgage fraud. It is an attack on the financial system that is as serious as money laundering because it perverts and

⁴ Remarks by Chairman Ben S. Bernanke At the Independent Community Bankers of America Annual National Convention and Techworld (March 8, 2006), available at <http://www.federalreserve.gov/boarddocs/speeches/2006/20060308/default.htm>.

⁵ Floyd Norris, “Officer Krupke, The Merger Made Me Do It,” *The New York Times*, March 7, 2006, p. C1.

abuses the system of modern mortgage finance that has in fact increased the opportunities available to all members of our society to own a home. Among my duties as Commissioner of Banks is regulation of mortgage bankers, brokers and loan originators who are not affiliated with depository institutions. In this activity, I have encountered originators and firms – more than a few I regret to tell you -- who have been active in the market and who are incompetent or crooked or both. While doing what I can to weed these characters out of the market, one question keeps rattling around in my brain: “Who on earth is buying from these people?” I know that a number of the major secondary market firms have risk management programs that weed out bad originators, but it is clear to me that these good practices are not universal.

There are two approaches to the problem of mortgage fraud with a chance of success: adoption of industry best practices and licensing. In North Carolina we are working on both approaches. The North Carolina Association of Mortgage Professionals has adopted an accreditation program that includes a higher continuing education component than is required by law, adoption of specific firm policies on ethics, treatment of customer financial information, and quality control, and mediation that has a reasonable chance of resolving complaints quickly and fairly. I have endorsed the NCAMP program⁶ and hope that it is the beginning of a dialog among stakeholders about how the mortgage industry can address fraud through voluntary means.

As many of you know, North Carolina requires licensing of non-bank firms and individuals involved in mortgage lending. This governmental approach to abuses in the marketplace is still in process of development but has the potential to be an important framework for supervision and regulation of the mortgage market. The efforts of a number of states in this regard have been subject to industry criticism of lack of uniformity, cumbersome application and general regulatory burden. In response to these criticisms, the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators are developing a national licensing system and database that will move governmental efforts toward uniformity and efficiency. As many of you are aware, a national system is also contemplated in legislation under consideration by Congress. The good news from my perspective, and I believe from yours, is that this state system is referred to specifically in the proposed legislation as a possible basis for a federal licensing system. However the licensing issue is resolved, I believe that a combination of licensing and industry best practices can move us toward a healthier mortgage industry that is still market driven.

The second of the two major challenges to the financial constitution is whether it delivers on the promise at the base of its claim to legitimacy: providing maximum opportunity to all members of society. There is little or no question that the range and availability of financial products and services to consumers has increased dramatically in recent times. There are real and substantial questions about (i) the suitability of some of such products for the consumers who use them to their harm and (ii) the availability at all of financial services to the members of our society who are unbanked or underbanked. I will discuss each of these issues briefly.

⁶ Joseph A. Smith, Jr., *Remarks Presented to the Annual Conference of the North Carolina Association of Mortgage Professionals*, March 6, 2006, available at <http://www.nccob.org/NCCOB/Researchers/CommissionersPage/default.htm> .

The increase in availability of consumer credit has resulted in what I call “the good, the bad and the ugly.” The “good” is the availability to people in all segments of our society of credit that can facilitate the purchase of education, homes, cars and other things of value. Properly used, the new credit products can enhance the quality of life of consumers and can be the basis for improvement of their circumstances. The “good,” however, accompanied by the “bad,” by which I mean increased foreclosures, repossessions and bankruptcies. It is also accompanied by the “ugly,” predatory lending practices and fraud. “Predatory lending” for purposes of this discussion includes putting low income / low wealth borrowers in products that make it more likely than not that they will default. For example, putting a single parent who is a night nurse into an interest only ARM with no down payment. The opportunity that is made available in this example is, to me, a delusion that generates fees but no value. Undoubtedly there are those here today who disagree with this analysis. I acknowledge that an application of the market-state test of legitimacy could find that provision of maximum opportunity includes my example and that the costs of an open market are outweighed by its many benefits. While I would defend to the death your right to that opinion, I think it is in all of our interests to deal with the externalities of an open market prospectively and efficiently.

The issue of the unbanked and underbanked Americans also is a challenge to the legitimacy of the current form of financial constitution, but of a different kind. I acknowledge that there are reasons that people are unbanked or underbanked that arise from policies designed to preserve safety and soundness (screening systems such as Chexsystems, documentation requirements), and to incent customers to responsible conduct (NSF fees). As a result, people who can't comply with bank operating rules are provided financial services by firms that are not banks and pay the fees and charges necessary to make such alternative services financially viable. Federal policy has attempted to address the issue of access through the Community Reinvestment Act. It has succeeded with regard to credit, the denial of which was its reason for being. The CRA has not successfully addressed access to the payments system and attempts to expand its coverage to access, which I support, are a stretch

If one accepts the argument that restriction of access to the payments system is a rational response of markets to the realities of life, then it seems to me that one also accepts the argument that serving the unbanked and underbanked is not part of “the business of banking” and, accordingly, that the appropriate policy to fulfill the promise of maximum opportunity for all members of society is to open this activity to all commercial firms with an interest in this business. To put the question more bluntly: Why am I against Wal-Mart's ILC? My friend Jerry Comizio has said recently that the Wal-Mart proceedings before the FDIC are historic in nature. For the reasons just mentioned, I couldn't agree more.

To sum up, we live in interesting times. All of us, in different ways, are stakeholders in a financial constitution that is radically different from the one that most of us started out with, which faces major challenges, and which promises to continue to change in the future. As a conservative of the traditional sort, my preferred approach to our challenges is to muddle through, preserving the role of supervisory agencies as mediators between the industry and the public and experimenting with ways to make the changes needed to deal with the worst externalities of our financial constitution without changing its basic nature. This is not the only

course available, I regret to say, so I think it is incumbent upon those of us who favor gradual change to work together to that end.

Thanks very much for allowing me to share my views with you today. I look forward to productive discussion of these issues during the rest of this seminar and in the future.