INTERNATIONAL FINANCE SPRING 2011
MATERIALS CHAPTER 6: BANKING REGULATION AND SECURITIES REGULATION COMPARED

Caroline Bradley[1]

OBJECTIVES OF BANKING REGULATION AND SECURITIES REGULATION

The US regulatory system and the transnational standard-setters that focus on financial regulation have different bodies which focus on different aspects of financial regulation. IOSCO, an organization of securities regulators, focuses on standards of securities regulation, whereas the Basel Committee focuses on banking regulation. Some domestic regulators are organized to regulate many different types of financial activity.[2] Shadow banking raises issues about how firms which perform functions like those of banks should be regulated. In February 2001, **Jean-**

[1] Professor of Law, University of Miami School of Law, PO Box 248087, Coral Gables, FL, 33124, cbradley@law.miami.edu ; http://blenderlaw.umlaw.net/ .

[2] For example the UK's Financial Services Authority (FSA). The UK Government has proposed to change the UK system to separate financial regulation into three components: responsibility for the stability of the financial system as a whole, the prudential regulation of individual firms, and consumer protection See HM Treasury, a New Approach to Financial Regulation: Building a Stronger System, CM 8012 (Feb. 2011) at http://www.hm-treasury.gov.uk/d/consult_newfinancial_regulation170211.pdf.

Claude Trichet, the President of the European Central Bank, said:

In addition to the necessary transposition into national or European law of the Basel III rules, there are two issues that still need to be addressed: systemically important financial institutions; and capturing the so-called shadow banking system within the regulatory framework.
Work is in progress on systemically important financial institutions, in particular in the Financial Stability Board. The main objectives are to reduce the probability of failure of such institutions and, in case a failure occurs, to reduce the impact on the financial system.
In September 2010, the Governors and Heads of Supervision agreed that systemically important financial institutions should have additional loss absorbing capacity. Work is currently underway on how to define institutions that are systemically important, and how to determine the capital surcharges, contingent capital and other elements to limit systemic fallout.
With the shadow banking system, we have to ensure that tighter regulatory rules do not provide incentives for financial institutions to shift their activities to unregulated areas. Oversight of the shadow banking sector needs to be improved. The FSB has already done valuable work – supported by the ECB – on shadow banking. In this context, the ECB is providing the Financial Stability Board (FSB) with flow of funds data on the composition of the financial sector concerning the euro area. The concrete challenges lie in the establishment of a suitable definition of shadow banking and outlining possible regulatory options to address the risks posed by this sector.
Given the background of the crisis, regulatory effort on financial institutions has focused on banking, but there is important work underway also for other financial institutions, such as the further specification of the capital adequacy regime for insurance companies. [3]

Daniel Tarullo, A Governor of the Federal Reserve has also addressed this issue:

... it is noteworthy that while the term "shadow banking system" has taken its place in the lexicon of policymakers alongside "systemic risk" and "financial stability," comparatively little has been done to regulate the channels of capital flows in which one or both transacting parties lie outside the perimeter of prudentially supervised institutions. This despite the often considerable degree of leverage and maturity transformation associated with many of these channels. In part, the relative lack of reform directed at the shadow banking system is a result of the fact that it was substantially disrupted by the financial crisis, and that some of its more unstable parts have fortunately disappeared. Yet there are certainly significant pieces that have survived and that serve important purposes in financial markets. I have already mentioned money market funds as one example. Although many broker-dealers are parts of bank holding companies, the breadth and significance of the repo market suggest that it may be another.
Just as important as dealing with systemic risks that might be posed by vestiges of the pre-crisis shadow

[3] Jean-Claude Trichet, President of the ECB, The Future of Risk Management and Regulation: Smarter regulation, safer markets, Speech at the Frankfurt Main Finance Summit (Mar. 23, 2011) at http://www.ecb.europa.eu/press/key/date/2011/html/sp110323.en.html.

banking system is the ability to monitor and, where necessary provide oversight for, the new conduits that are almost surely to develop in the future. In fact, it may be useful to require some systematic and standardized reporting by some classes of nonbank-affiliated firms, even without a designation under section 113.

With respect to both old and new channels, there is an important and growing academic literature on various aspects of the shadow banking system. There is now a formal exercise sponsored by the Financial Stability Board to identify policy approaches and options for ensuring that the shadow banking system does not again grow so as to pose a threat to financial stability. My hope is that these sources will serve as a catalyst for more active policy discussion and, eventually, action. In the absence of appropriate regulatory, and possibly legislative, action, the section 113 designation tool will inevitably bear more of the weight in policies crafted to contain systemic risk. [4]

Section 113 of the Dodd-Frank Act:

Sec. 113. Authority to Require Supervision and Regulation Of Certain Nonbank Financial Companies. (A) US Nonbank Financial Companies Supervised by the Board of Governors.. (1) Determination..The Council,[5] on a nondelegable basis and by a vote of not fewer than 2.3 of the voting members then serving, including an affirmative vote by the Chairperson, may determine that a U.S. nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards, in accordance with this title, if the Council determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.

(2) Considerations..In making a determination under paragraph (1), the Council shall consider. (A) the extent of the leverage of the company; (B) the extent and nature of the off-balance-sheet exposures of the company; (C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (D) the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system; (E) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities; (F) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets

[4] Governor Daniel K. Tarullo, Regulating Systemic Risk, Speech at the 2011 Credit Markets Symposium, Charlotte, North Carolina (Mar. 31, 2011) at http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.htm.

[5] This is the Financial Stability Oversight Council (a interagency council) : http://www.treasury.gov/initiatives/Pages/FSOC-index.aspx . The FSOC published a NPR on the criteria for the designation of non-bank financial companies. See 76 Fed. Reg. 4555 (Jan. 26, 2011).

under management is diffuse; (G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (H) the degree to which the company is already regulated by 1 or more primary financial regulatory agencies; (I) the amount and nature of the financial assets of the company; (J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and (K) any other risk-related factors that the Council deems appropriate
(b) Foreign Nonbank Financial Companies Supervised by The Board of Governors..
(1) Determination..The Council... may determine that a foreign nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards, in accordance with this title, if the Council determines that material financial distress at the foreign nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the foreign nonbank financial company, could pose a threat to the financial stability of the United States.
(2) Considerations.—In making a determination under paragraph (1), the Council shall consider— (A) the extent of the leverage of the company; (B) the extent and nature of the United States related off-balance-sheet exposures of the company; (C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (D) the importance of the company as a source of credit for United States households, businesses, and State and local governments and as a source of liquidity for the United States financial system; (E) the importance of the company as a source of credit for low-income, minority, or underserved communities in the United States, and the impact that the failure of such company would have on the availability of credit in such communities; (F) the extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse; (G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (H) the extent to which the company is subject to prudential standards on a consolidated basis in its home country that are administered and enforced by a comparable foreign supervisory authority; (I) the amount and nature of the United States financial assets of the company; (J) the amount and nature of the liabilities of the company used to fund activities and operations in the United States, including the degree of reliance on short term funding; and (K) any other risk-related factors that the Council deems appropriate.
(c) Antievasion.. (1) Determinations..In order to avoid evasion of this title, the Council, on its own initiative or at the request of the Board of Governors, may determine... that.
(A) material financial distress related to, or the nature, scope, size, scale, concentration, interconnectedness, or mix of, the financial activities conducted directly or indirectly by a company incorporated or organized under the laws of the United States or any State or the financial activities in the United States of a company incorporated or organized in a country other than the United States would pose a threat to the financial stability of the United States, based on consideration of the factors in subsection (a)(2) or (b)(2), as applicable;
(B) the company is organized or operates in such a manner as to evade the application of this title; and
(C) such financial activities of the company shall be supervised by the Board of Governors and subject to prudential standards in accordance with this title, consistent with paragraph (3).

(2) Report.—Upon making a determination under paragraph (1), the Council shall submit a report to the appropriate committees of Congress detailing the reasons for making such determination.
(3) Consolidated Supervision of Only Financial Activities; Establishment of an Intermediate Holding Company.—
(A) Establishment of an Intermediate Holding Company.—Upon a determination under paragraph (1), the company that is the subject of the determination may establish an intermediate holding company in which the financial activities of such company and its subsidiaries shall be conducted (other than the activities described in section 167(b)(2)) in compliance with any regulations or guidance provided by the Board of Governors. Such intermediate holding company shall be subject to the supervision of the Board of Governors and to prudential standards under this title as if the intermediate holding company were a nonbank financial company supervised by the Board of Governors.
(B) Action of the Board of Governors.—To facilitate the supervision of the financial activities subject to the determination in paragraph (1), the Board of Governors may require a company to establish an intermediate holding company, as provided for in section 167, which would be subject to the supervision of the Board of Governors and to prudential standards under this title, as if the intermediate holding company were a nonbank financial company supervised by the Board of Governors.
(4) Notice and Opportunity for Hearing and Final Determination; Judicial Review.—Subsections (d) through (h) shall apply to determinations made by the Council pursuant to paragraph (1) in the same manner as such subsections apply to nonbank financial companies.
(5) Covered Financial Activities.—For purposes of this subsection, the term ''financial activities''—
(A) means activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956);
(B) includes the ownership or control of one or more insured depository institutions; and
(C) does not include internal financial activities conducted for the company or any affiliate thereof, including internal treasury, investment, and employee benefit functions.
(6) Only Financial Activities Subject to Prudential Supervision.—Nonfinancial activities of the company shall not be subject to supervision by the Board of Governors and prudential standards of the Board. For purposes of this Act, the financial activities that are the subject of the determination in paragraph (1) shall be subject to the same requirements as a nonbank financial company supervised by the Board of Governors. Nothing in this paragraph shall prohibit or limit the authority of the Board of Governors to apply prudential standards under this title to the financial activities that are subject to the determination in paragraph (1).
(d) Reevaluation and Rescission..The Council shall. (1) not less frequently than annually, reevaluate each determination made under subsections (a) and (b) with respect to such nonbank financial company supervised by the Board of Governors; and (2) rescind any such determination, if the Council, by a vote of not fewer than 2.3 of the voting members then serving, including an affirmative vote by the Chairperson, determines that the nonbank financial company no longer meets the standards under subsection (a) or (b), as applicable.
(E) Notice and Opportunity for Hearing and Final Determination..

(1) in General..The Council shall provide to a nonbank financial company written notice of a proposed determination of the Council, including an explanation of the basis of the proposed determination of the Council, that a nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards in accordance with this title.
(2) Hearing..Not later than 30 days after the date of receipt of any notice of a proposed determination under paragraph (1), the nonbank financial company may request, in writing, an opportunity for a written or oral hearing before the Council to contest the proposed determination. Upon receipt of a timely request, the Council shall fix a time (not later than 30 days after the date of receipt of the request) and place at which such company may appear, personally or through counsel, to submit written materials (or, at the sole discretion of the Council, oral testimony and oral argument).
(3) Final Determination..Not later than 60 days after the date of a hearing under paragraph (2), the Council shall notify the nonbank financial company of the final determination of the Council, which shall contain a statement of the basis for the decision of the Council.
(4) No Hearing Requested..If a nonbank financial company does not make a timely request for a hearing, the Council shall notify the nonbank financial company, in writing, of the final determination of the Council under subsection (a) or (b), as applicable, not later than 10 days after the date by which the company may request a hearing under paragraph (2).
(F) Emergency Exception..
(1) in General..The Council may waive or modify the requirements of subsection (e) with respect to a nonbank financial company, if the Council determines,... that such waiver or modification is necessary or appropriate to prevent or mitigate threats posed by the nonbank financial company to the financial stability of the United States.
(2) Notice.—The Council shall provide notice of a waiver or modification under this subsection to the nonbank financial company concerned as soon as practicable, but not later than 24 hours after the waiver or modification is granted.
(3) International Coordination.—In making a determination under paragraph (1), the Council shall consult with the appropriate home country supervisor, if any, of the foreign nonbank financial company that is being considered for such a determination.
(4) Opportunity for Hearing.—The Council shall allow a nonbank financial company to request, in writing, an opportunity for a written or oral hearing before the Council to contest a waiver or modification under this subsection, not later than 10 days after the date of receipt of notice of the waiver or modification by the company. Upon receipt of a timely request, the Council shall fix a time (not later than 15 days after the date of receipt of the request) and place at which the nonbank financial company may appear, personally or through counsel, to submit written materials (or, at the sole discretion of the Council, oral testimony and oral argument).
(5) Notice of Final Determination.—Not later than 30 days after the date of any hearing under paragraph (4), the Council shall notify the subject nonbank financial company of the final determination of the Council under this subsection, which shall contain a statement of the basis for the decision of the Council.

(g) Consultation.—The Council shall consult with the primary financial regulatory agency, if any, for each nonbank financial company or subsidiary of a nonbank financial company that is being considered for supervision by the Board of Governors under this section before the Council makes any final determination with respect to such nonbank financial company under subsection (a), (b), or (c).
(h) Judicial Review.—If the Council makes a final determination under this section with respect to a nonbank financial company, such nonbank financial company may, not later than 30 days after the date of receipt of the notice of final determination under subsection (d)(2), (e)(3), or (f)(5), bring an action in the United States district court for the judicial district in which the home office of such nonbank financial company is located, or in the United States District Court for the District of Columbia, for an order requiring that the final determination be rescinded, and the court shall, upon review, dismiss such action or direct the final determination to be rescinded. Review of such an action shall be limited to whether the final determination made under this section was arbitrary and capricious.
(i) International Coordination.—In exercising its duties under this title with respect to foreign nonbank financial companies, foreign-based bank holding companies, and cross-border activities and markets, the Council shall consult with appropriate foreign regulatory authorities, to the extent appropriate.

What do you think are likely to be the advantages and disadvantages of the Section 113 designation process?

Securities regulation is designed to protect the interests of purchasers of securities (by regulating issuers and the disclosures they make about the securities they issue, and by regulating participants in the securities issuance and trading process (underwriters, broker-dealers) and the integrity of the securities markets (for example, by controlling fraud).

Banking regulation, like securities regulation, is in part about the maintenance of confidence in aspects of the financial markets. Banking regulators want to avoid bank runs. They want to protect depositors (note that we assume that bank depositors are likely to be more risk averse than investors in securities - they want a safe place for their money rather than just an opportunity to make a profit). Banking regulators also want to ensure the safety and soundness of banks as key elements in the payments system. Securities regulators have not traditionally seen their role as involving the protection of the payments system, therefore ensuring the safety and soundness of securities firms has been a less visible, and less significant feature of securities regulation.

Form the perspective of the regulation of securities issuance by banks, if banking regulators regulate the safety and soundness of banks effectively we should perhaps not worry too much about having the SEC regulate the issuance of securities by banks.[6]

After the 1929 market crash US legislators required there to be a separation between commercial banking and securities business so that commercial banks were prohibited from underwriting issues of securities. These restrictions were reduced over time, and eliminated by the Gramm-Leach-Bliley Act of 1999 which allowed US banks to engage in "broad banking". Some foreign banks, such as German universal banks, had been permitted to engage in a wider range of activities than were permitted to US banks under Glass-Steagall, and US banks wanted to be able to compete more effectively with banks chartered in other jurisdictions.

As a result of the expansion of the permitted range of activities for banks chartered in the US, the regulators needed to address the issues of which regulator would be responsible for regulating securities activities of banks. Regulation R defines exceptions for banks and savings associations from the definition of the term "broker" under Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act"), as amended by the Gramm-Leach-Bliley Act ("GLBA").[7]

IOSCO's Objectives and Principles of Securities Regulation [8] are based on protecting investors; ensuring that markets are fair, efficient and transparent; and reducing systemic risk:

A. Principles Relating to the Regulator

1 The responsibilities of the Regulator should be clear and objectively stated.

2 The Regulator should be operationally independent and accountable in the exercise of its functions and powers.

3 The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.

4 The Regulator should adopt clear and consistent regulatory processes.

---

[6] Securities "issued or guaranteed by any bank" are exempt from registration under 33 Act s 3(a)(2) (securities exemption, not transaction exemption) but not from 34 Act provisions. A bank is a "national bank or, or banking institution organized under the laws of any Stat, territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official". This does not include foreign banks.

[7] Federal Reserve System, SEC, Definitions of Terms and Exemptions Relating to the ''Broker'' Exceptions for Banks and Exemptions for Banks Under Section 3(a)(5) of the Securities Exchange Act of 1934 and Related Rules, 72 Fed. Reg. 56514 (Oct. 3, 2007) amended at 73 Fed. Reg. 20779 (Apr. 17, 2008).

[8] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf (Jun. 2010).

5 The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality.
6 The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.
7 The Regulator should have or contribute to a process to review the perimeter of regulation regularly.
8 The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.

B. Principles for Self-Regulation
9 Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

C. Principles for the Enforcement of Securities Regulation
10 The Regulator should have comprehensive inspection, investigation and surveillance powers.
11 The Regulator should have comprehensive enforcement powers.
12 The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

D. Principles for Cooperation in Regulation
13 The Regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
14 Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.
15 The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

E. Principles for Issuers
16 There should be full, accurate and timely disclosure of financial results, risk and other information which is material to investors' decisions.
17 Holders of securities in a company should be treated in a fair and equitable manner.
18 Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.

F. Principles for Auditors, Credit Ratings Agencies, and other information service providers
19 Auditors should be subject to adequate levels of oversight.
20 Auditors should be independent of the issuing entity that they audit.
21 Audit standards should be of a high and internationally acceptable quality.

22 Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.
23 Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.

G. Principles for Collective Investment Schemes
24 The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme.
25 The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.
26 Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
27 Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.
28 Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.

H. Principles for Market Intermediaries
29 Regulation should provide for minimum entry standards for market intermediaries.
30 There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.
31 Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.
32 There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

I. Principles for Secondary Markets
33 The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.
34 There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
35 Regulation should promote transparency of trading.
36 Regulation should be designed to detect and deter manipulation and other unfair trading practices.

37 Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
38 Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

The **Basel Committee's Core Principles for Effective Banking Supervision** , published in 2006, are set out below:

LIST OF CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION[9]
Preconditions for Effective Banking Supervision
1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Licensing and Structure
2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.
3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.
4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.
5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Prudential Regulations and Requirements
6. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all

[9] The document is at http://www.bis.org/publ/bcbs30a.pdf

banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.
7. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.
8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.
9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.
10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.
11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.
12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.
14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision
16. An effective banking supervisory system should consist of some form of both on-site and off-site

supervision.
17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.
18. Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.
19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.
20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Information Requirements
21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Formal Powers of Supervisors
22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

Cross-border Banking
23. Banking supervisors must practise global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.
24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.
25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

These two sets of principles are among the standards the IMF focuses on in its Reports on the Observance of Standards and Codes,[10] and that the World Bank considers as part of its Financial Sector Assessment Program. How useful do you think the standards are?

In January 2010 the **Joint Forum** wrote:[11]

International financial regulation is sector specific as evidenced by the independent development of core principles or standards in each financial sector. A sector-specific approach to supervision comes with the potential for increasing regulatory gaps, which causes supervisory challenges and presents opportunities for regulatory arbitrage. Differences exist in the nature of financial regulation among the banking, insurance, and securities sectors. These differences are warranted in some cases due to specific attributes of each financial sector, but, in others, these differences may contribute to gaps in the regulation of the financial system as a whole. One way to understand the differences and identify the gaps is to compare the core principles for financial supervision across each sector. The core principles reflect characteristics of the respective sector and the nature of the supervised financial institutions. They represent the key components and features of the supervisory and regulatory framework of each financial sector. These principles, issued independently by the BCBS, IAIS, and IOSCO, correspond to the minimum requirements for sound supervision.

Applying the Basel and IOSCO principles can be complex due to the intricacies of domestic regulatory systems. As well as the issues of how responsibilities for different areas of financial regulation (securities, banking, insurance etc) may be split between different regulators within different national systems, different countries allocate responsibilities for banking supervision differently. In the US a number of different federal agencies currently have responsibilities in relation to banking regulation. The **Office of the Comptroller of the Currency** (OCC)[12] is the primary federal regulator for national banks.[13] The **Federal Reserve**

[10] List of Standards, Codes and Principles Useful for Bank and Fund Operational Work and for which Reports on the Observance of Standards and Codes Are Produced at http://www.imf.org/external/standards/scnew.htm .

[11] Joint Forum, Review of the Differentiated Nature and Scope of Financial Regulation - Key Issues and Recommendations, 3 (Jan. 2010) at http://www.bis.org/publ/joint24.htm

[12] http://www.occ.treas.gov . The Dodd-Frank Act integrates the Office of Thrift Supervision into the OCC.

[13] In the US, banks may be chartered at the federal level as national banks or at the state level. This is the dual banking system (see below).

Board (Fed)[14] is the main federal regulator for state-chartered banks which are members of the Federal Reserve System, and the **FDIC** (Federal Deposit Insurance Corporation)[15] is the main federal regulator for state chartered banks which are not members of the Federal Reserve System. Often the federal banking regulators act together in proposing new federal banking regulations,[16] and they are required to report to Congress on differences in their capital standards and accounting standards. The following excerpt is from the regulators' 2010 **Joint Report on Differences in Accounting and Capital Standards Among the Federal Banking Agencies**:[17]

Since the agencies filed their first reports on accounting and capital differences in 1990, the agencies have acted in concert to harmonize their accounting and capital standards and eliminate as many differences as possible. Section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4803) also directed the agencies to work jointly to make uniform all regulations and guidelines implementing common statutory or supervisory policies. The results of these efforts must be "consistent with the principles of safety and soundness, statutory law and policy, and the public interest." In recent years, the agencies have revised their capital standards to address changes in credit and certain other risk exposures within the banking system and to align the amount of capital institutions are required to hold more closely with the credit risks and certain other risks to which they are exposed. These revisions have been made in a uniform manner whenever possible and practicable to minimize interagency differences.

While the differences in capital standards have diminished over time, a few differences remain. Some of the remaining capital differences are statutorily mandated. Others were significant historically but now no longer affect in a measurable way, either individually or in the aggregate, institutions supervised by the federal banking agencies.

In addition to the specific differences in capital standards .. the agencies may have differences in how they apply certain aspects of their rules. These differences usually arise as a result of case-specific inquiries that have only been presented to one agency. Agency staffs seek to minimize these occurrences by coordinating responses to the fullest extent reasonably practicable. Furthermore, while the agencies work together to adopt and apply generally uniform capital standards, there are wording differences in various provisions of the agencies' standards that largely date back to each agency's

---

14 http://www.federalreserve.gov/ .

15 http://www.fdic.gov/ .

16 *See, e.g.*, Proposed Rule on Incentive-based Compensation Arrangements at http://www.fdic.gov/news/news/press/2011/pr11061a.pdf .

17 75 Fed. Reg. 47900 (Aug. 9, 2010).

separate initial adoption of these standards before 1990.

The federal banking agencies have substantially similar capital adequacy standards. These standards employ a common regulatory framework that establishes minimum leverage and risk-based capital ratios for all banking organizations (banks, bank holding companies, and savings associations). The agencies view the leverage and risk-based capital requirements as minimum standards, and most institutions are expected to operate with capital levels well above the minimums, particularly those institutions that are expanding or experiencing unusual or high levels of risk.

Furthermore, in December 2007, the federal banking agencies issued a new common risk-based capital adequacy framework, “Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II.” The final rule requires some qualifying banking organizations, and permits other qualifying banking organizations, to use an advanced internal ratings-based approach to calculate regulatory credit risk capital requirements and advanced measurement approaches to calculate regulatory operational risk capital requirements. It describes the qualifying criteria for banking organizations required or seeking to operate under the new framework and the applicable risk-based capital requirements for banking organizations that operate under the framework. Because the agencies adopted a joint final rulemaking establishing a common framework, there are no differences among the agencies' Basel II rules.

The risk-based capital differences described below have arisen under the agencies' Basel I-based risk-based capital standards...

The Gramm-Leach-Bliley Act (GLBA) establishes the framework for financial subsidiaries of banks. GLBA amends the National Bank Act to permit national banks to conduct certain expanded financial activities through financial subsidiaries. Section 121(a) of the GLBA (12 U.S.C. 24a) imposes a number of conditions and requirements upon national banks that have financial subsidiaries, including specifying the treatment that applies for regulatory capital purposes. The statute requires that a national bank deduct from assets and tangible equity the aggregate amount of its equity investments in financial subsidiaries. The statute further requires that the financial subsidiary's assets and liabilities not be consolidated with those of the parent national bank for applicable capital purposes.

State member banks may have financial subsidiaries subject to all of the same restrictions that apply to national banks. State nonmember banks may also have financial subsidiaries, but they are subject only to a subset of the statutory requirements that apply to national banks and state member banks. Finally, national banks, state member banks, and state nonmember banks may not establish or acquire a financial subsidiary or commence a new activity in a financial subsidiary if the bank, or any of its insured depository institution affiliates, has received a less than satisfactory rating as of its most recent examination under the Community Reinvestment Act.

The OCC, the FDIC, and the FRB adopted final rules implementing their respective provisions of Section 121 of GLBA for national banks in March 2000, for state nonmember banks in January 2001, and for state member banks in August 2001..

Under the federal banking agencies' capital standards, noncumulative perpetual preferred stock is a component of Tier 1 capital. The capital standards of the OCC, the FRB, and the FDIC require noncumulative perpetual preferred stock to give the issuer the option to waive the payment of dividends and to provide that waived dividends neither accumulate to future periods nor represent a contingent claim on the issuer.

As a result of these requirements, if a bank supervised by the OCC, the FRB, or the FDIC issues perpetual preferred stock and is required to pay dividends in a form other than cash, e.g., stock, when cash dividends are not or cannot be paid, the bank does not have the option to waive or eliminate dividends, and the stock would not qualify as noncumulative...

The FRB, the FDIC, and the OTS apply a 100 percent risk weight to equity securities of government-sponsored enterprises (GSEs), other than the 20 percent risk weighting of Federal Home Loan Bank stock held by banking organizations as a condition of membership. The OCC applies a 20 percent risk weight to all GSE equity securities...

Under the **International Banking Act**, a foreign bank which wants to do business in the US is required to obtain authorization to do so. If it wishes to establish a federal branch or agency it requires the approval of the OCC, if it wishes to establish a state branch, agency or representative office it requires the approval of the Federal Reserve. In practice, foreign banks doing business in the US tend to establish state branches or agencies.[18]

12 USC § 3105

...**(d) Establishment of foreign bank offices in United States**

(1) Prior approval required

No foreign bank may establish a branch or an agency, or acquire ownership or control of a commercial lending company, without the prior approval of the Board.

(2) Required standards for approval

Except as provided in paragraph (6), the Board may not approve an application under paragraph (1) unless it determines that-- (A) the foreign bank engages directly in the business of banking outside of the United States and is subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country; and (B) the foreign bank has furnished to the Board the information it needs to adequately assess the application.

(3) Standards for approval

In acting on any application under paragraph (1), the Board may take into account--

(A) whether the appropriate authorities in the home country of the foreign bank have consented to the proposed establishment of a branch, agency or commercial lending company in the United States by the foreign bank;

(B) the financial and managerial resources of the foreign bank, including the bank's experience and capacity to engage in international banking;

---

[18] *See generally* Foreign Banks and the Federal Reserve at http://www.newyorkfed.org/aboutthefed/fedpoint/fed26.html

(C) whether the foreign bank has provided the Board with adequate assurances that the bank will make available to the Board such information on the operations or activities of the foreign bank and any affiliate of the bank that the Board deems necessary to determine and enforce compliance with this chapter, the Bank Holding Company Act of 1956 [12 U.S.C. 1841 et seq.], and other applicable Federal law; and

(D) whether the foreign bank and the United States affiliates of the bank are in compliance with applicable United States law.

(4) Factor

In acting on an application under paragraph (1), the Board shall not make the size of the foreign bank the sole determinant factor, and may take into account the needs of the community as well as the length of operation of the foreign bank and its relative size in its home country. Nothing in this paragraph shall affect the ability of the Board to order a State branch, agency, or commercial lending company subsidiary to terminate its activities in the United States pursuant to any standard set forth in this chapter.

(5) Establishment of conditions

The Board may impose such conditions on its approval under this subsection as it deems necessary.

(6) Exception

(A) In general

If the Board is unable to find, under paragraph (2), that a foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country, the Board may nevertheless approve an application by such foreign bank under paragraph (1) if--

(i) the appropriate authorities in the home country of the foreign bank are actively working to establish arrangements for the consolidated supervision of such bank; and (ii) all other factors are consistent with approval.

(B) Other considerations

In deciding whether to use its discretion under subparagraph (A), the Board shall also consider whether the foreign bank has adopted and implements procedures to combat money laundering. The Board may also take into account whether the home country of the foreign bank is developing a legal regime to address money laundering or is participating in multilateral efforts to combat money laundering.

(C) Additional conditions

In approving an application under this paragraph, the Board, after requesting and taking into consideration the views of the appropriate State bank supervisor or the Comptroller of the Currency, as the case may be, may impose such conditions or restrictions relating to the activities or business operations of the proposed branch, agency, or commercial lending company subsidiary, including restrictions on sources of funding, as are considered appropriate. The Board shall coordinate with the appropriate State bank supervisor or the Comptroller of the Currency, as appropriate, in the implementation of such conditions or restrictions.

(D) Modification of conditions

Any condition or restriction imposed by the Board in connection with the approval of an application under authority of this paragraph may be modified or withdrawn.

(7) Time period for Board action

(A) Final action

The Board shall take final action on any application under paragraph (1) not later than 180 days after receipt of the application, except that the Board may extend for an additional 180 days the period within which to take final action on such application after providing notice of, and the reasons for, the extension to the applicant foreign bank and any appropriate State bank supervisor or the Comptroller of the Currency, as appropriate.

(B) Failure to submit information

The Board may deny any application if it does not receive information requested from the applicant foreign bank or appropriate authorities in the home country of the foreign bank in sufficient time to permit the Board to evaluate such information adequately within the time periods for final action set forth in subparagraph (A).

(C) Waiver

A foreign bank may waive the applicability of this paragraph with respect to any application under paragraph (1).

(e) Termination of foreign bank offices in United States

(1) Standards for termination

The Board, after notice and opportunity for hearing and notice to any appropriate State bank supervisor, may order a foreign bank that operates a State branch or agency or commercial lending company subsidiary in the United States to terminate the activities of such branch, agency, or subsidiary if the Board finds that--

(A)(i) the foreign bank is not subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country; and

(ii) the appropriate authorities in the home country of the foreign bank are not making demonstrable progress in establishing arrangements for the comprehensive supervision or regulation of such foreign bank on a consolidated basis; or

(B)(i) there is reasonable cause to believe that such foreign bank, or any affiliate of such foreign bank, has committed a violation of law or engaged in an unsafe or unsound banking practice in the United States; and

(ii) as a result of such violation or practice, the continued operation of the foreign bank's branch, agency or commercial lending company subsidiary in the United States would not be consistent with the public interest or with the purposes of this chapter, the Bank Holding Company Act of 1956 [12 U.S.C. 1841 et seq.], or the Federal Deposit Insurance Act [12 U.S.C. 1811 et seq.].

However, in making findings under this paragraph, the Board shall not make size the sole determinant factor, and may take into account the needs of the community as well as the length of operation of the foreign bank and its relative size in its home country. Nothing in this paragraph shall affect the ability of the Board to order a State branch, agency, or commercial lending company subsidiary to terminate its activities in the United States pursuant to any standard set forth in this chapter.

(2) Discretion to deny hearing

The Board may issue an order under paragraph (1) without providing for an opportunity for a hearing if the Board determines that expeditious action is necessary in order to protect the public interest.

(3) Effective date of termination order

An order issued under paragraph (1) shall take effect before the end of the 120-day period beginning on the date such order is issued unless the Board extends such period.

(4) Compliance with State and Federal law

Any foreign bank required to terminate activities conducted at offices or subsidiaries in the United States pursuant to this subsection shall comply with the requirements of applicable Federal and State law with respect to procedures for the closure or dissolution of such offices or subsidiaries....

(6) Enforcement of orders

(A) In general

In the case of contumacy of any office or subsidiary of the foreign bank against which– (i) the Board has issued an order under paragraph (1); or(ii) the Comptroller of the Currency has issued an order under section 3102(i) of this title,or a refusal by such office or subsidiary to comply with such order, the Board or the Comptroller of the Currency may invoke the aid of the district court of the United States within the jurisdiction of which the office or subsidiary is located.

(B) Court order

Any court referred to in subparagraph (A) may issue an order requiring compliance with an order referred to in subparagraph (A).

(7) Criteria relating to foreign supervision

Not later than 1 year after December 19, 1991, the Board, in consultation with the Secretary of the Treasury, shall develop and publish criteria to be used in evaluating the operation of any foreign bank in the United States that the Board has determined is not subject to comprehensive supervision or regulation on a consolidated basis. In developing such criteria, the Board shall allow reasonable opportunity for public review and comment.

(f) Judicial review

(1) Jurisdiction of United States courts of appeals

Any foreign bank--

(A) whose application under subsection (d) of this section or section 3107(a) of this title has been disapproved by the Board;

(B) against which the Board has issued an order under subsection (e) of this section or section 3107(b) of this title; or

(C) against which the Comptroller of the Currency has issued an order under section 3102(i) of this title, may obtain a review of such order in the United States court of appeals for any circuit in which such foreign bank operates a branch, agency, or commercial lending company that has been required by such order to terminate its activities, or in the United States Court of Appeals for the District of Columbia Circuit, by filing a petition for review in the court before the end of the 30-day period beginning on the date the order was issued.

(2) Scope of judicial review
Section 706 of title 5 (other than paragraph (2)(F) of such section) shall apply with respect to any review under paragraph (1).
(g) Consultation with State bank supervisor
The Board shall request and consider any views of the appropriate State bank supervisor with respect to any application or action under subsection (d) or (e) of this section.
(h) Limitations on powers of State branches and agencies
(1) In general
After the end of the 1-year period beginning on December 19, 1991, a State branch or State agency may not engage in any type of activity that is not permissible for a Federal branch unless--(A) the Board has determined that such activity is consistent with sound banking practice; and(B) in the case of an insured branch, the Federal Deposit Insurance Corporation has determined that the activity would pose no significant risk to the deposit insurance fund.
(2) Single borrower lending limit
A State branch or State agency shall be subject to the same limitations with respect to loans made to a single borrower as are applicable to a Federal branch or Federal agency under section 3102(b) of this title.
(3) Other authority not affected
This section does not limit the authority of the Board or any State supervisory authority to impose more stringent restrictions.
(i) Proceedings related to conviction for money laundering offenses
(1) Notice of intention to issue order
If the Board finds or receives written notice from the Attorney General that--
(A) any foreign bank which operates a State agency, a State branch which is not an insured branch, or a State commercial lending company subsidiary; (B) any State agency; (C) any State branch which is not an insured branch; or (D) any State commercial lending subsidiary,
has been found guilty of any money laundering offense, the Board shall issue a notice to the agency, branch, or subsidiary of the Board's intention to commence a termination proceeding under subsection (e) of this section.
(2) Definitions
For purposes of this subsection--
(A) Insured branch
The term ``insured branch'' has the meaning given such term in section 3(s) of the Federal Deposit Insurance Act [12 U.S.C. 1813(s)].
(B) Money laundering offense defined
The term ``money laundering offense'' means any criminal offense under section 1956 or 1957 of title 18 or under section 5322 of title 31....
(k) Management of shell branches
(1) Transactions prohibited

A branch or agency of a foreign bank shall not manage, through an office of the foreign bank which is located outside the United States and is managed or controlled by such branch or agency, any type of activity that a bank organized under the laws of the United States, any State, or the District of Columbia is not permitted to manage at any branch or subsidiary of such bank which is located outside the United States.
(2) Regulations
Any regulations promulgated to carry out this section--(A) shall be promulgated in accordance with section 3108 of this title; and
(B) shall be uniform, to the extent practicable.

The Federal Reserve's Regulation K deals with foreign operations of US banks and US operations of foreign banks.[19]

ARE BANKS DIFFERENT FROM OTHER FINANCIAL INSTITUTIONS ?

We have noticed that banks rely on other financial institutions to acquire credit risk from them by means of loan sales, loan participations and credit default swaps, and that this type of activity has some implications for financial stability. Banks are subject to different regulatory regimes from other financial institutions. But there is some blurring between the functions banks and other financial institutions perform. In **Essar Steel v the Argo Fund** [20] we saw that the UK Court of Appeal considered whether a hedge fund was a financial institution for the purposes of a provision in the LMA standard form syndicated loan agreement limiting loan transfers.

In 2006, Marl Olson, then a Governor of the Federal Reserve Board,[21] argued that banks are special:[22]

Much has changed in the banking landscape since Corrigan wrote his essay twenty-four years ago. Significant increases in international capital flows among bank and nonbank entities, in addition to a broad range of specialized financial instruments mean banks can no longer be considered the only source of transaction accounts. Except for their access to the Federal Reserve discount window, banks

---

[19] You can access Regulation K at http://www.federalreserve.gov/bankinforeg/reglisting.htm .

[20] http://www.bailii.org/ew/cases/EWCA/Civ/2006/241.html

[21] Mark Olson was Chairman of the Public Company Accounting Oversight Board from 2006-9.

[22] See http://www.bis.org/review/r060322c.pdf . Mr. Olson refers to an essay written by Gerald Corrigan in 1982: “Are Banks Special”.

are no longer the dominant provider of liquidity for other financial industries. But banks remain the key access point to the dominant wholesale payments network, and they still provide federally insured checking and savings deposits. With the rise of new financial services, products, and techniques, moreover, banks have expanded their role in providing liquidity in more indirect ways, for example, through securitization of loans and backup commitments to securitization vehicles and other capital-markets instruments. Even when banks may not be "special" or unique providers in a particular market, banks have proven themselves to be formidable competitors and innovators--which only reinforces banks' importance in the proper functioning of our financial system. In short, the public's trust and confidence in banking continue to be vital to our financial well-being.

Banks provided considerable credit in the aftermath of the September 11 attacks, when financial flows were slowed by operational problems. To be sure, banks were able to provide this credit in part because of the huge injection of liquidity provided by the Federal Reserve. But that is a key role for banks in a crisis: to obtain funds--through the discount window or from open market operations, if necessary--and to channel them to those needing funds, based on an assessment of their creditworthiness. Banks' access to the discount window and the payments system, as well as their ongoing relationships with customers and their credit-evaluation skills, allow them to play this role. During a crisis, those banks that play critical roles in the payments system are especially important. As a result, these banks are expected to be very resilient. Though banks now have a smaller role in transmitting monetary policy, they still help to transmit policy actions by arbitraging between the federal funds market and other money markets.

US: DUAL BANKING REGULATION

In the US, banks may be chartered by the states or by the Office of the Comptroller of the Currency (OCC). Banks chartered by the OCC are known as national banks. The OCC also regulates federal branches and agencies of foreign banks. This separation of functions between the states and the federal authorities is sometimes problematic as states may want to impose rules on banks carrying on business on their territory and the federal authorities may be sensitive about issues of pre-emption in relation to national banks. The following **excerpt from a speech**[23] **by Mark W. Olson** discusses whether dual banking regulation is a good thing or not:

Importance of the Dual Banking System...

... the significance of the uniquely American dual banking system. Our country's founders established a federal system of government, dividing power and responsibilities between the state governments and the central government. Perhaps less well known to the public is that, since the Civil War, our banking system has developed along similar lines. State banks were, of course, first. But the dynamic tension between centralization and decentralization in U.S. banking is as old as the debate between Thomas

[23] http://www.federalreserve.gov/boarddocs/speeches/2002/20020531/default.htm

Jefferson and Alexander Hamilton over the First Bank of the United States. For a time, after the demise of the Second Bank of the United States in 1836, the forces of state banking were in ascendance. Then, with the passage of the National Bank Act of 1863, nationally chartered banks arrived on the scene. At the time, with the tax on state bank notes, some thought state banks would fade away. Instead, they innovated--by emphasizing demand deposits--and prospered. In typically American fashion, the compromise that has been worked out over time is to have it both ways. We have nationally chartered banks supervised by the federal government and state-chartered banks supervised by both state and federal regulators. The Federal Reserve System itself also reflects this American preference for dispersal of authority. In 1913 the Congress, fearful of central authority, attempted to create a set of regional central banks. Today the twelve Reserve Banks, with the Board of Governors in Washington, provide the regional representation and authority so dear to the American psyche.

Over the years, the dual banking system has provided many innovations. Forced to find a substitute for the issuance of state bank notes that were taxed out of the market by the National Bank Act of 1863, state banks pioneered demand deposits. Much more recently, a state-chartered bank invented the NOW account, which was the opening shot in the long campaign to remove national controls from interest rates on deposits. And the 1994 interstate branching statute was essentially the epilogue to the interstate banking movement, which had begun a decade before then through the establishment of regional interstate compacts. If memory serves, forty-nine of the fifty states had passed some form of interstate banking legislation before the federal government acted on this issue. After the 1994 Reigle-Neal Act, the state banking commissioners combined their efforts to provide for the orderly and consistent supervision of state banks with a multistate presence. I believe the results are a tribute both to the resilience of state banking and, not incidentally, to the leadership of the Conference of State Bank Supervisors.

Now that interstate banking is a reality, I submit that the dual banking system remains an important factor underlying the strength and flexibility of our financial system. As Chairman Greenspan has reminded us in the past, the freedom of banks to choose their regulator is the key to the protection of banks from the potential for unreasonable regulatory behavior. Some are concerned, of course, that the freedom to choose could lead to a "competition in laxity" among regulatory agencies. To be sure, we must guard against that possibility by ensuring the highest standards of supervision as well as the availability of resources and staffing to implement those standards. But I believe that the ability of banks to choose their regulator has fostered both the continued competitiveness of the industry and vitality of the economic activity it finances.

As an aside, let me add that the Federal Reserve, as a central bank responsible for the nation's monetary policy and financial stability, benefits enormously from the insight gleaned from hands-on responsibility for supervising, in partnership with state supervisors, a portion of the banking industry. That is one reason why the Federal Reserve should remain in the bank regulatory business.

See also the following **speech by John Hawke, (then) the Comptroller of the**

Currency:[24]

...Even during our colonial period, Americans recognized that banks were necessary to meet the financial needs of the modern state and a developing economy. At the same time, banks were viewed with deep suspicion, if not hostility. Thomas Jefferson, the primary author of our Declaration of Independence, believed that banks were "more dangerous than standing armies." Yet even Jefferson did not believe that the country could afford to dispense with banks altogether. Indeed, America needed banks even more than Britain did, for ours was a young, undeveloped, and far-flung country noticeably lacking in the great private accumulations of liquid wealth with which England was blessed. In order to mobilize capital in such a place, banks were essential. In fact, Americans concluded that if we were to have any banks at all, we should have many of them – not only to serve potential customers for bank services, but also to discourage the rise of a small number of large and powerful institutions capable of exercising dangerous dominance over local economies.

From this reasoning flowed one of the most distinctive characteristics of the U.S. banking system. At its high water mark, in 1921, there were no fewer than 29,000 independent commercial banks in America. Even today, after decades of industry contraction, there are more than 8000 U.S. banking companies, a number not equaled anywhere else in the world...Viewed purely as an economic arrangement, this banking structure has probably never made much sense. Any system based on thousands of independent, mostly small, institutions might be viewed as a system inevitably lacking in stability and efficiency. But Americans were willing to sacrifice those qualities in a conscious trade off to preserve other values they cherished even more: competition, individual initiative, local responsiveness, and opportunity. Branch banking, despite its real economic benefits, was seen as a threat to those values – and as a step toward financial concentration and monopoly. That's why branching and bank consolidation were systematically suppressed by state and federal laws – some of which remained in effect until just a few years ago.

Americans did not depend entirely on the structure of their banking system to curb potential abuses of banking power. Government oversight and enforcement were also viewed as essential. But here too there have been inhibitions. Americans have always been uneasy with the idea of government intervention in the economy. Our experience as a colony left our people with deep suspicions of government authority -- suspicions that linger to this day. The arrangements formalized in the U.S. Constitution, with its provisions for checks and balances and power sharing between the national government and the states, reflected these suspicions. Thus, in the same way – and for many of the same political reasons -- that U.S. banks were encouraged to proliferate, a system of multiple bank chartering and regulatory authorities arose. During the first half of the 19th century, the states dominated the field of banking. Each carried out its own program of bank chartering and supervision, reflecting wide

[24] John D. Hawke, Jr., Comptroller of the Currency, Remarks at a Session on Banking Supervision with the People's Bank of China Beijing, China (Oct. 14, 2002) at http://www.occ.gov/static/news-issuances/speeches/2002/pub-speech-2002-80.pdf.

variances in rigor and competence. The federal government's involvement was sporadic -- and generally unwelcome. Not until the American Civil War, which redefined the relationship between the central government and the states, did a federal presence become a permanent part of the U.S. banking system in the form of the Office of the Comptroller of the Currency and the national banking system, which our office supervises. I am proud to be the 28th person to hold the Office of the Comptroller of the Currency since our founding in 1863.

It is significant that when the U.S. Congress created the national banking system, it did not choose to abolish state-chartered banking at the same time. Given the advantages they built into the national charter, some lawmakers felt that such an outcome -- a system consisting exclusively of national banks -- was assured. But the state banks proved equal to the competitive challenge, and, as your slide shows, the U.S. has ever since had a dual system of state and national banks, under which national banks operate under the primary supervision of the OCC and state banks under the primary supervision of the 50 state banking departments.

Dual banking made for a complicated regulatory system that would soon grow more complicated still. But Americans didn't necessarily see regulatory complexity as a bad thing. It was viewed instead as a safeguard against the dangers of regulatory hegemony and abuse – and as an incentive to regulatory responsiveness and efficiency. Dividing regulatory authority between the federal government and the states – and then dividing it again, over a period of years, among three separate federal agencies – ensured that no single agency would be able to gain meaningful dominance. And because regulatory authority was checked and balanced in this way, Congress felt safe in endowing the OCC with considerable independence, both from its own control as well as from that of the executive branch within which the OCC was positioned.

The decision to create the OCC as an independent agency was quite an extraordinary step, and it was one that reflected Congress's understanding of the importance of supervision in the nation's overall banking scheme. Although formally a "bureau" of the Treasury Department – indeed, until the 1970s, the Comptroller's offices were actually housed within the main Treasury building in Washington -- the OCC has always enjoyed considerable operational autonomy. Although appointed by the President with Senate confirmation, the president cannot remove the Comptroller before the expiration of the statutory five-year term without providing to the Senate in writing a statement of his reasons for doing so.

Just within the past decade, Congress passed additional legislation reaffirming the OCC's ability to submit legislative recommendations and testimony to Congress without prior approval or review in the Executive Branch. Moreover, Congress has forbidden the Treasury Department from intervening in any matter or proceeding before us, or from delaying or preventing the issuance of any rule or regulation by the OCC. I
speak from personal experience – as Under Secretary of the Treasury for Domestic Finance before moving to the OCC – when I say that these rules have been scrupulously respected.

These structural firewalls have made it possible to successfully insulate the OCC from occasional pressures to support particular fiscal or monetary policies or to appoint politically connected individuals to supervisory positions. One measure of that success lies in the fact that my staff in Washington consists of civil servants who work under the merit system; while national bank examiners, of which there are currently more than 1500, have been recruited from the nation's universities and financial institutions, and commissioned after passing through a rigorous program of classroom instruction, on-the-job training, and continuing education. I hope you will not accuse me of being immodest when I say that our peers at home and abroad regard the OCC as the premier bank regulatory agency. But it's true.

So far, I have just spoken of one phase of OCC independence – independence from the executive branch of the federal government. Our relationship with Congress is somewhat different. Of course, the OCC is subject to all laws that Congress may make, and the Comptroller is regularly called upon to provide testimony on subjects of interest to legislators. But a crucial element of this relationship is the fact that we – unlike virtually all other agencies of our government -- do not depend upon Congress to provide the funds we depend upon to finance our activities.

That is in accordance with Congress's own plan. In creating the OCC and the national banking system, it chose to remove the OCC from the normal budget and appropriations process – to remove it, that is, from its own direct control. It recognized that the power to approve a budget may confer an ability to direct policy, and that subjecting bank supervisors to the give-and-take of budget negotiations would inevitably lead to pressures for supervisory compromises. Thus, in a historic act of self-denial, Congress chose to restrict its own influence and authority rather than compromising the ability of the OCC to conduct its operations objectively and with independence. Instead, in a system that has continued to operate without interruption since the 1860s, banks are subject to annual fee assessments by the OCC, which since 1914 have been asset-based. They also pay fees to cover the cost of processing corporate applications. Those two sources together account for nearly 97 percent of the OCC's $413 million annual budget.

Our ability to deliver independent and professional bank supervision owes in large measure to the wisdom and selflessness of those who created the national banking system as a self-supported, self-financing entity.

Our longstanding belief that independence is crucial to effective bank supervision has received repeated confirmation elsewhere in the world. Indeed, the absence of supervisory independence has been implicated in almost every national financial crisis the world has recently seen. In Argentina, South Korea, Thailand, Japan, Turkey, and Indonesia, bank supervisors were unable to operate with the independence their responsibilities demanded. In each case, supervisors became instruments of government or central bank policies that subordinated the safety and soundness of financial institutions to other goals. In each case, banks were permitted -- or even encouraged -- to make loans in defiance of good credit practices in order to promote certain policy objectives, such as protecting inefficient industries. Moreover, in each case, the result was the same: supervision was discredited; the condition of the banking system deteriorated; the national economy suffered; and the process of recovery was seriously impeded by a crippled banking system. Some countries are still struggling with the consequences of such ill-advised supervisory policies.

These experiences help explain why, when the Basel Committee on Banking Supervision adopted its core principles for effective supervision in 1997, "operational independence and adequate resources" headed the list. And the experiences of other countries remind us of the importance of vigilance in defending supervisory independence here at home.

On another crucial issue of supervisory structure, however, global practice is less conclusive. That is the role of central banks – and, to a lesser degree, the deposit insurance agencies – in the supervisory arena. In this area there have been a wide variety of experiences and results. Many of the world's countries have opted to separate monetary policy from bank supervision. Austria, Canada, Germany, Japan, Norway, Mexico, and, recently, the United Kingdom, among others, have taken the step of removing the central bank from the supervisory function. The rationale is that there are inherent conflicts of interest between the two roles – that the goals of monetary policy – and a solvent deposit insurance fund – may not coincide with the demands of a safe, sound, and competitive banking system. For example, a central bank may decide that its overall monetary and macroeconomic objectives are better served by infusing capital into an insolvent institution, whereas the pure supervisor might have opted to close the bank. Similarly, the deposit insurer, if also endowed with supervisory responsibilities, may take a supervisory position that is highly adverse to risk-taking – good for the loss-ratios of the insurance fund, but perhaps not so good for the competitiveness of banks and their customers.

In the United States, nonetheless, we entrust the Federal Reserve and the Federal Deposit Insurance Corporation with significant responsibilities for bank supervision... state-chartered banks in America, in addition to their state supervisors, each have one primary federal bank supervisor: the FDIC if it's a state-chartered bank that is not a member of the Federal Reserve system (membership is optional for all state banks and mandatory for OCC-supervised national banks), and the Federal Reserve if the state bank is a Fed member.

We are often asked to explain why this complicated regulatory structure arose – and why we have not attempted systematically to simplify it. The question of origins has a relatively straightforward answer. I have already spoken of Americans' enduring suspicion of concentrated political authority and their belief that establishing multiple and competing government bureaucracies would serve to check their ambitions and excesses. Thus, when the Federal Reserve System was created in 1914 – becoming the second federal agency with a bank supervisory mission – Congress simply layered it on top of the existing supervisory structure and parceled supervisory authority between the new Fed and the OCC. The same pattern held in 1933, when the FDIC – the third of the federal banking agencies -- was created.

So it was not political cowardice, as some have suggested, that led Congress to avoid trying to abolish one agency when creating another to perform essentially the same, or a complimentary, function -- although as you well know, abolishing government bureaucracies is never an easy task. There is a positive rationale for multiple agencies: that competition can be as productive in the public sector as in the private. In the case of bank supervision, the assumption has been that the agencies would each do their jobs better with bureaucratic competitors in the mix, challenging them to excel. Whether or not this was Congress's rationale, most agree that it has been the happy result.

In the case of U.S. banking, regulatory competition can take on a particular edge, because U.S. banks have the extraordinary ability not only to choose their chartering agency, but also to switch charters if they grow dissatisfied with the manner in which they're supervised. It's in the direct self-interest of the primary supervisors that depend upon assessment funding – the states and the OCC –to provide high quality, cost-effective supervision. And by most accounts, we do just that.

The other main reason why this somewhat unwieldy structure arose was because both the Federal Reserve and the FDIC made compelling cases in favor of their receiving significant supervisory responsibilities. The Fed has argued that it needs a "window" into the banking system to assist it in carrying out monetary policy, and the FDIC has made a plausible argument that the insurer's interests – and the health of the deposit insurance funds -- must be taken into account in supervisory decisions that are likely to affect them. Thus, in addition to their routine responsibilities for state-chartered banks – responsibilities that, as already noted, are shared with state authorities -- both the Fed and the FDIC have back-up supervisory authority for national banks that can be exercised in problem bank situations.

Once the Federal Reserve and the FDIC became permanent parts of our supervisory structure, the complexion of the U.S. dual banking system changed. Laws passed by Congress that were meant to apply to state as well as national banks were increasingly entrusted for administration to the federal supervisors of state banks, whose compliance with Congress's wishes could be better monitored. Thus, as your chart shows, most of the supervisory activities concerning state-chartered banks are carried out not by the states, but by the Federal Reserve and the FDIC. So there is probably less "duality" today than there has ever been in the 140-year history of the U.S. dual banking system.

As to why our system has persisted despite its unwieldiness, there are a couple of points to consider. The first is that there has never been a clear and compelling consensus for change. The U.S. banking industry and other interest groups have learned to live with – and take advantage of – our existing system. For them, change would be unwelcome. But even those groups that might be expected to support supervisory rationalization – consumer and public interest groups, for example -- have been not expressed that support in any consistent or unified way. And the regulatory agencies themselves have never been enthusiastic about proposals to simplify supervision – especially when simplification would occur at their expense.

A second reason why our structure has remained in place is that the U.S. regulatory agencies, through trial and error, have learned to work effectively within it. We have created formal mechanisms for coordinating our efforts and avoiding duplication and unnecessary burden on U.S. financial institutions, as well as informal avenues for information sharing and consultation. I believe that the relationships that exist among U.S. supervisors validate the concept that lies at the heart of our structure – that competition among regulatory agencies can enhance the quality of supervision and help prevent it from becoming unduly burdensome for financial institutions.

The final and perhaps most important reason why our regulatory structure works is that it is an authentic reflection of our country's habits of mind and practice. While international experience suggests certain core principles of effective bank supervision – independence being chief among them -- every country must find its own way of implementing those principles, in a manner consistent with its own culture and institutions. That is what the United States has successfully done over a period of many years. And that is one of the great challenges that confront the People's Republic of China. We at the OCC are delighted to assist in any way in that effort.

Do you think it is possible to reconcile Hawke's concern for cultural differences with regulatory harmonization?

States make it clear they are competing to attract banks to charter with them. They say that the state banking officials will be accessible, that the charges they impose are lower than the OCC's charges, and that the regulators and rules are local.[25] In addition states often have parity statutes which allow state banks to have many of the benefits they would derive from a national charter.

Here is the Florida statute (**Section 655.061, Florida Statutes**):

> Subject to the prior approval of OFR pursuant to rule or order of general application, state financial institutions subject to the financial institutions codes may make any loan or investment or exercise any power which they could make or exercise if incorporated or operating in this state as a federally chartered or regulated financial institution of the same type and are entitled to all privileges and protections granted federally chartered or regulated financial institutions of the same type under federal statutes and regulations. The provisions of this section take precedence over, and must be given effect over, any other general or specific provisions of the financial institution's codes to the contrary. In issuing an order under this section, OFR shall consider the importance of maintaining a competitive dual system of financial institutions and whether such order is in the public interest.

Do you think that the competition for bank charters is likely to produce better bank regulation overall? Better banks? Do you think that depositors are likely to know whether their bank is a national bank or a state chartered bank? How would you go about finding out? Is your bank a state bank or a national bank?

This question may matter. States sometimes try to regulate what banks do within their territory.

[25] See, e.g., http://www.flofr.com/banking/state_charter.htm .

In particular, states enacted statutes to control predatory lending.[26] Predatory lenders impose unfair terms on their customers. Where predatory loans are mortgage loans borrowers may lose their homes.[27] The statutes tend to be drafted to cover lending within the state rather than lending by state chartered banks. This makes some sense if borrowers cannot easily distinguish between state chartered and national banks and therefore cannot easily work out what rules would regulate predatory lending. However, national banks objected to being subjected to these state laws on the basis that they are pre-empted. A major concern underlying the objection was the impact of state predatory lending laws on securitizations. Rating agencies addressed these issues. For example, Standard & Poor's stated in 2003 that it considered whether predatory lending statutes provide for assignee liability, whether the loan categories affected are clearly defined, what penalties apply and how clear the statute is (including safe harbors).[28] Rating agencies and lenders suggested that if state statutes made it hard for lenders to securitize loans the legislation would be counter-productive and cut off access to credit for borrowers:

> GAFLA, with its complicated structure, ambiguous provisions and undefined terms, has created uncertainty, and the secondary market has reacted strongly and negatively. The reaction was to be expected on 'high cost' loans, as the large, national buyers of home loans such as Fannie Mae and Freddie Mac do not buy those loans. However, the market has also reacted negatively to 'covered' loans primarily due to the uncertainty created by the wording of the Act. No other state or federal anti-predatory lending laws include a category of mid-priced loans in their statutes, and loans made in Georgia will continue to be treated with suspicion by the secondary market. The national buyers of mortgage loans have changed their underwriting standards and now require lenders to agree to take back any loans made under GAFLA if a compliance failure is found – even years

---

[26] Sometimes described as "abusive lending". *See*, *e.g.*, OCC notice for Request of Pre-emption Determination or Order relating to the Georgia Fair Lending Act, 68 Fed. Reg.8959 (Feb. 26, 2003).

[27] Opponents of predatory lending referred to "asset stripping" or "equity stripping" which can happen because of large fees charged in relation to the loans. *See*, *e.g.*, Center for Responsible Lending, Comments on OCC Working Paper (Oct. 6, 2003) ("The primary abuse the North Carolina law, and other subsequent state laws, is aimed at is preventing equity stripping, which occurs when lenders charge excessive fees. The problem of excessive fees for the subprime refinancing borrower is two-fold: the fees seem painless at closing and they are forever. They are *deceptively costless* to many borrowers because when the borrower "pays" them, with a stroke of a pen at closing, he or she does not feel the pain of counting out thousands of dollars in cash. The borrower parts with the money only later, when the loan is paid off and the equity value remaining in his or her home is reduced by the amount of fees owed. And *fees are forever* because, even if a responsible lender refinances a family a week later, the borrowers' wealth is still permanently stripped away.")

[28] http://www.housingchoice.org/news%20stories/04152003.htm

after the loan was closed, sold or even paid off.[29]

In January 2004 the OCC issued two rules: one on Bank Activities and Operations; Real Estate Lending and Appraisals[30] and the other on Bank Activities and Operations.[31] These rules attempt to delineate when state rules may impact national banks and when they may not.

In **Watters v. Wachovia Bank**[32] the Supreme Court held that the National Banking Act operated to pre-empt state rules with respect to a subsidiary of a national bank:

Business activities of national banks are controlled by the National Bank Act and regulations promulgated thereunder by the Office of the Comptroller of the Currency (OCC). As the agency charged by Congress with supervision of the NBA, OCC oversees the operations of national banks and their interactions with customers. The agency exercises visitorial powers, including the authority to audit the bank's books and records, largely to the exclusion of other governmental entities, state or federal.
The NBA specifically authorizes federally chartered banks to engage in real estate lending. It also provides that banks shall have power "[t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking." Among incidental powers, national banks may conduct certain activities through "operating subsidiaries," discrete entities authorized to engage solely in activities the bank itself could undertake, and subject to the same terms and conditions as those applicable to the bank.
Respondent Wachovia Bank, a national bank, conducts its real estate lending business through Wachovia Mortgage Corporation, a wholly owned, state-chartered entity, licensed as an operating subsidiary by OCC. It is uncontested in this suit that Wachovia's real estate business, if conducted by the national bank itself, would be subject to OCC's superintendence, to the exclusion of state registration requirements and visitorial authority. The question in dispute is whether the bank's mortgage lending activities remain outside the governance of state licensing and auditing agencies when those activities are conducted, not by a division or department of the bank, but by the bank's operating subsidiary. In accord with the Courts of Appeals that have addressed the issue, we hold that Wachovia's mortgage business, whether conducted by the bank itself or through the bank's operating subsidiary, is subject to OCC's superintendence, and not to the licensing, reporting, and visitorial regimes of the several States

[29] The Georgia Bankers Association White Paper, Georgia Fair Lending Act. The Unintended Consequences 5 (Jan. 2003).

[30] 69 Fed. Reg. 1904 (Jan 13, 2004).

[31] 69 Fed. Reg 1895 (Jan 13, 2004).

[32] 550 U.S. 1 (2007).

in which the subsidiary operates.
Wachovia Bank is a national banking association chartered by OCC. Respondent Wachovia Mortgage is a North Carolina corporation that engages in the business of real estate lending in the State of Michigan and elsewhere. Michigan's statutory regime exempts banks, both national and state, from state mortgage lending regulation, but requires mortgage brokers, lenders, and servicers that are subsidiaries of national banks to register with the State's Office of Financial and Insurance Services (OFIS) and submit to state supervision. From 1997 until 2003, Wachovia Mortgage was registered with OFIS to engage in mortgage lending. As a registrant, Wachovia Mortgage was required, inter alia, to pay an annual operating fee, file an annual report, and open its books and records to inspection by OFIS examiners.
Petitioner Linda Watters, the commissioner of OFIS, administers the State's lending laws. She exercises "general supervision and control" over registered lenders, and has authority to conduct examinations and investigations and to enforce requirements against registrants. She also has authority to investigate consumer complaints and take enforcement action if she finds that a complaint is not "being adequately pursued by the appropriate federal regulatory authority."
On January 1, 2003, Wachovia Mortgage became a wholly owned operating subsidiary of Wachovia Bank. Three months later, Wachovia Mortgage advised the State of Michigan that it was surrendering its mortgage lending registration. Because it had become an operating subsidiary of a national bank, Wachovia Mortgage maintained, Michigan's registration and inspection requirements were preempted. Watters responded with a letter advising Wachovia Mortgage that it would no longer be authorized to conduct mortgage lending activities in Michigan.
Wachovia Mortgage and Wachovia Bank filed suit against Watters, in her official capacity as commissioner, in the United States District Court for the Western District of Michigan. They sought declaratory and injunctive relief prohibiting Watters from enforcing Michigan's registration prescriptions against Wachovia Mortgage, and from interfering with OCC's exclusive visitorial authority. The NBA and regulations promulgated thereunder, they urged, vest supervisory authority in OCC and preempt the application of the state-law controls at issue. Specifically, Wachovia Mortgage and Wachovia Bank challenged as preempted certain provisions of two Michigan statutes--the Mortgage Brokers, Lenders, and Services Licensing Act and the Secondary Mortgage Loan Act. The challenged provisions (1) require mortgage lenders--including national bank operating subsidiaries but not national banks themselves--to register and pay fees to the State before they may conduct banking activities in Michigan, and authorize the commissioner to deny or revoke registrations, (2) require submission of annual financial statements to the commissioner and retention of certain documents in a particular format, (3) grant the commissioner inspection and enforcement authority over registrants, and (4) authorize the commissioner to take regulatory or enforcement actions against covered lenders.
In response, Watters argued that, because Wachovia Mortgage was not itself a national bank, the challenged Michigan controls were applicable and were not preempted. She also contended that the Tenth Amendment to the Constitution of the United States prohibits OCC's exclusive superintendence of national bank lending activities conducted through operating subsidiaries.....

Nearly 200 years ago, in McCulloch v. Maryland this Court held.federal law supreme over state law with respect to national banking. Though the bank at issue in McCulloch was short-lived, a federal banking system reemerged in the Civil War era. In 1864, Congress enacted the NBA, establishing the system of national banking still in place today. The Act vested in nationally chartered banks enumerated powers and "all such incidental powers as shall be necessary to carry on the business of banking." To prevent inconsistent or intrusive state regulation from impairing the national system, Congress provided: "No national bank shall be subject to any visitorial powers except as authorized by Federal law . . . ."

In the years since the NBA's enactment, we have repeatedly made clear that .federal control shields national banking from unduly burdensome and duplicative state regulation...Federally chartered banks are subject to state laws of general application in their daily business to the extent such laws do not conflict with the letter or the general purposes of the NBA. For example, state usury laws govern the maximum rate of interest national banks can charge on loans, contracts made by national banks "are governed and construed by State laws," and national banks'"acquisition and transfer of property [are] based on State law,"..However, "the States can exercise no control over [national banks], nor in any wise affect their operation, except in so far as Congress may see proper to permit. Any thing beyond this is an abuse, because it is the usurpation of power which a single State cannot give."

We have "interpret[ed] grants of both enumerated and incidental 'powers' to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law." States are permitted to regulate the activities of national banks where doing so does not prevent or significantly interfere with the national bank's or the national bank regulator's exercise of its powers. But when state prescriptions significantly impair the exercise of authority, enumerated or incidental under the NBA, the State's regulations must give way.

The NBA authorizes national banks to engage in mortgage lending, subject to OCC regulation. The Act provides:

"Any national banking association may make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate, subject to 1828(o) of this title and such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order."

Beyond genuine dispute, state law may not significantly burden a national bank's own exercise of its real estate lending power, just as it may not curtail or hinder a national bank's efficient exercise of any other power, incidental or enumerated under the NBA. In particular, real estate lending, when conducted by a national bank, is immune from state visitorial control: The NBA specifically vests exclusive authority to examine and inspect in OCC..("No national bank shall be subject to any visitorial powers except as authorized by Federal law.").

Harmoniously, the Michigan provisions at issue exempt national banks from coverage. This is not simply a matter of the Michigan Legislature's grace. For, as the parties recognize, the NBA would have preemptive force, i.e., it would spare a national bank from state controls of the kind here involved. State laws that conditioned national banks' real estate lending on registration with the State, and subjected such lending to the State's investigative and enforcement machinery would surely interfere with the banks' federally authorized business: National banks would be subject to registration, inspection, and enforcement regimes imposed not just by Michigan, but by all States in which the banks operate. Diverse and duplicative superintendence of national banks' engagement in the business of banking, we observed over a century ago, is precisely what the NBA was designed to prevent: "Th[e] legislation has in view the erection of a system extending throughout the country, and independent, so far as powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States." Congress did not intend, we explained, "to leave the field open for the States to attempt to promote the welfare and stability of national banks by direct legislation. . . . [C]onfusion would necessarily result from control possessed and exercised by two independent authorities."

Recognizing the burdens and undue duplication state controls could produce, Congress included in the NBA an express command: "No national bank shall be subject to any visitorial powers except as authorized by Federal law. . . ." "Visitation," we have explained "is the act of a superior or superintending officer, who visits a corporation to examine into its manner of conducting business, and enforce an observance of its laws and regulations." ..Michigan, therefore, cannot confer on its commissioner examination and enforcement authority over mortgage lending, or any other banking business done by national banks.

While conceding that Michigan's licensing, registration, and inspection requirements cannot be applied to national banks, ..Watters argues that the State's regulatory regime survives preemption with respect to national banks' operating subsidiaries. Because such subsidiaries are separately chartered under some State's law, Watters characterizes them simply as "affiliates" of national banks, and contends that even though they are subject to OCC's superintendence, they are also subject to multistate control. We disagree.

Since 1966, OCC has recognized the "incidental" authority of national banks .. to do business through operating subsidiaries. That authority is uncontested by Michigan's commissioner. ..OCC licenses and oversees national bank operating subsidiaries just as it does national banks.

In 1999, Congress defined and regulated "financial" subsidiaries; simultaneously, Congress distinguished those national bank affiliates from subsidiaries--typed "operating subsidiaries" by OCC--which may engage only in activities national banks may engage in directly, "subject to the same terms and conditions that govern the conduct of such activities by national banks." Gramm-Leach-Bliley Act (GLBA).. For supervisory purposes, OCC treats national banks and their operating subsidiaries as a single economic enterprise. OCC oversees both entities by reference to "business line," applying the same controls whether banking "activities are conducted directly or through an operating subsidiary."

As earlier noted, Watters does not contest the authority of national banks to do business through operating subsidiaries. Nor does she dispute OCC's authority to supervise and regulate operating subsidiaries in the same manner as national banks. Still, Watters seeks to impose state regulation on operating subsidiaries over and above regulation undertaken by OCC. But just as duplicative state examination, supervision, and regulation would significantly burden mortgage lending when engaged in by national banks, so too would those state controls interfere with that same activity when engaged in by an operating subsidiary.

We have never held that the preemptive reach of the NBA extends only to a national bank itself. Rather, in analyzing whether state law hampers the federally permitted activities of a national bank, we have focused on the exercise of a national bank's powers, not on its corporate structure. And we have treated operating subsidiaries as equivalent to national banks with respect to powers exercised under federal law (except where federal law provides otherwise). In NationsBank of N. C., for example, we upheld OCC's determination that national banks had "incidental" authority to act as agents in the sale of annuities. It was not material that the function qualifying as within "the business of banking," was to be carried out not by the bank itself, but by an operating subsidiary, i.e., an entity "subject to the same terms and conditions that govern the conduct of [the activity] by national banks [themselves],"

Security against significant interference by state regulators is a characteristic condition of the "business of banking" conducted by national banks, and mortgage lending is one aspect of that business. That security should adhere whether the business is conducted by the bank itself or is assigned to an operating subsidiary licensed by OCC whose authority to carry on the business coincides completely with that of the bank...

Watters contends that if Congress meant to deny States visitorial powers over operating subsidiaries, it would have written § 484(A)'s ban on state inspection to apply not only to national banks but also to their affiliates. She points out that § 481, which authorizes OCC to examine "affiliates" of national banks, does not speak to state visitorial powers. This argument fails for two reasons. First, one cannot ascribe any intention regarding operating subsidiaries to the 1864 Congress that enacted §§ 481 and 484, or the 1933 Congress that added the provisions on examining affiliates to § 481 and the definition of "affiliate" to § 221a. That is so because operating subsidiaries were not authorized until 1966. Over the past four decades, during which operating subsidiaries have emerged as important instrumentalities of national banks, Congress and OCC have indicated no doubt that such subsidiaries are "subject to the same terms and conditions" as national banks themselves.

Second, Watters ignores the distinctions Congress recognized among "affiliates." The NBA broadly defines the term "affiliate" to include "any corporation" controlled by a national bank, including a subsidiary. An operating subsidiary is therefore one type of "affiliate." But unlike affiliates that may engage in functions not authorized by the NBA, e.g., financial subsidiaries, an operating subsidiary is tightly tied to its parent by the specification that it may engage only in "the business of banking" as authorized by the Act. Notably, when Congress amended the NBA confirming that operating subsidiaries may "engag[e] solely in activities that national banks are permitted to engage in directly," it did so in an Act, the GLBA, providing that other affiliates, authorized to engage in nonbanking financial activities, e.g., securities and insurance, are subject to state regulation in connection with those activities.

Recognizing the necessary consequence of national banks' authority to engage in mortgage lending through an operating subsidiary "subject to the same terms and conditions that govern the conduct of such activities by national banks," OCC promulgated 12 CFR § 7.4006 (2006): "Unless otherwise provided by Federal law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank." Watters disputes the authority of OCC to promulgate this regulation and contends that, because preemption is a legal question for determination by courts, § 7.4006 should attract no deference. This argument is beside the point, for under our interpretation of the statute, the level of deference owed to the regulation is an academic question. Section 7.4006 merely clarifies and confirms what the NBA already conveys: A national bank has the power to engage in real estate lending through an operating subsidiary, subject to the same terms and conditions that govern the national bank itself; that power cannot be significantly impaired or impeded by state law.

The NBA is thus properly read by OCC to protect from state hindrance a national bank's engagement in the "business of banking" whether conducted by the bank itself or by an operating subsidiary, empowered to do only what the bank itself could do. The authority to engage in the business of mortgage lending comes from the NBA, § 371, as does the authority to conduct business through an operating subsidiary. That Act vests visitorial oversight in OCC, not state regulators. State law (in this case, North Carolina law), all agree, governs incorporation-related issues, such as the formation, dissolution, and internal governance of operating subsidiaries. And the laws of the States in which national banks or their affiliates are located govern matters the NBA does not address. But state regulators cannot interfere with the "business of banking" by subjecting national banks or their OCC-licensed operating subsidiaries to multiple audits and surveillance under rival oversight regimes.

In **Cuomo v. Clearing House Association** [33] the Supreme Court distinguished between the exercise of visitorial powers (which was pre-empted by the NBA) and judicial enforcement actions brought by the Attorney General. Justice Scalia wrote:

Historically, the sovereign's right of visitation over corporations paralleled the right of the church to supervise its institutions and the right of the founder of a charitable institution "to see that [his] property [was] rightly employed," .. By extension of this principle, "[t]he king [was] by law the visitor of all civil corporations," A visitor could inspect and control the visited institution at will.

When the National Bank Act was enacted in 1864, "visitation" was accordingly understood as "[t]he act of examining into the affairs of a corporation" by "the government itself." .. Lower courts understood "visitation" to mean "the act of a superior or superintending officer, who visits a corporation to examine into its manner of conducting business, and enforce an observance of its laws and regulations."... A State was the "visitor" of all companies incorporated in the State, simply by virtue of the State's role as sovereign: The "legislature is the visitor of all corporations founded by it."..

This relationship between sovereign and corporation was understood to allow the States to use prerogative writs--such as mandamus and quo warranto--to exercise control "whenever a corporation [wa]s abusing the power given it, or, . . . or acting adversely to the public, or creating a nuisance."... State visitorial commissions were authorized to "exercise a general supervision" over companies in the State...

---

[33] 129 S. Ct. 2710 (2009).

Our cases have always understood "visitation" as this right to oversee corporate affairs, quite separate from the power to enforce the law In the famous Dartmouth College case, Justice Story, describing visitation of a charitable corporation, wrote that Dartmouth was "subject to the controlling authority of its legal visitor, who . . . may amend and repeal its statutes, remove its officers, correct abuses, and generally superintend the management of [its] trusts," and who are "liable to no supervision or control." .. This power of "genera[l] superintend[ence]" stood in contrast to action by the court of chancery, which acted "not as itself possessing a visitorial power . . . but as possessing a general jurisdiction . . . to redress grievances, and frauds."

In Guthrie, supra, we held that a shareholder acting in his role as a private individual was not exercising a "visitorial power" under the National Bank Act when he petitioned a court to force the production of corporate records,.. "[C]ontrol in the courts of justice," we said, is not visitorial, and we drew a contrast between the nonvisitorial act of "su[ing] in the courts of the State" and the visitorial "supervision of the Comptroller of the Currency,"..

In First Nat. Bank in St. Louis v. Missouri .. we upheld the right of the Attorney General of Missouri to bring suit to enforce a state anti-bank-branching law against a national bank. We said that only the United States may perform visitorial administrative oversight such as "inquir[ing] by quo warranto whether a national bank is acting in excess of its charter powers." But if a state statute of general applicability is not substantively pre-empted, then "the power of enforcement must rest with the [State] and not with" the National Government..

Our most recent decision, Watters v. Wachovia Bank does not, as the dissent contends "suppor[t] OCC's construction of the statute." To the contrary, it is fully in accord with the well established distinction between supervision and law enforcement. Watters held that a State may not exercise "'general supervision and control'" over a subsidiary of a national bank because "multiple audits and surveillance under rival oversight regimes" would cause uncertainty " [G]eneral supervision and control" and "oversight" are worlds apart from law enforcement. All parties to the case agreed that Michigan's general oversight could not be imposed on national banks; the sole question was whether operating subsidiaries of national banks enjoyed the same immunity from state visitation. The opinion addresses and answers no other question.

The foregoing cases all involve enforcement of state law. But if the Comptroller's exclusive exercise of visitorial powers precluded law enforcement by the States, it would also preclude law enforcement by federal agencies. Of course it does not.

In sum, the unmistakable and utterly consistent teaching of our jurisprudence, both before and after enactment of the National Bank Act, is that a sovereign's "visitorial powers" and its power to enforce the law are two different things. There is not a credible argument to the contrary. And contrary to what the Comptroller's regulation says, the National Bank Act pre-empts only the former...

The consequences of the regulation also cast doubt upon its validity. No one denies that the National Bank Act leaves in place some state substantive laws affecting banks. .. But the Comptroller's rule says that the State may not enforce its valid, non-pre-empted laws against national banks. . The bark remains, but the bite does not.

The dissent admits, with considerable understatement, that such a result is "unusual," "Bizarre" would be more apt. As the Court said in St. Louis:

"To demonstrate the binding quality of a statute but deny the power of enforcement involves a fallacy made apparent by the mere statement of the proposition, for such power is essentially inherent in the very conception of law."

In sharp contrast to the "unusual" reading propounded by the Comptroller's regulation, reading "visitorial powers" as limiting only sovereign oversight and supervision would produce an entirely commonplace result--the precise result contemplated by our opinion in St. Louis, which said that if a state statute is valid as to national banks, "the corollary that it is obligatory and enforceable necessarily results."... Channeling state attorneys general into judicial law-enforcement proceedings (rather than allowing them to exercise "visitorial" oversight) would preserve a regime of exclusive administrative oversight by the Comptroller while honoring in fact rather than merely in theory Congress's decision not to pre-empt substantive state law. This system echoes many other mixed state/federal regimes in which the Federal Government exercises general oversight while leaving state substantive law in place.

This reading is also suggested by § 484(a)'s otherwise inexplicable reservation of state powers "vested in the courts of justice." As described earlier, visitation was normally conducted through use of the prerogative writs of mandamus and quo warranto. The exception could not possibly exempt that manner of exercising visitation, or else the exception would swallow the rule. Its only conceivable purpose is to preserve normal civil and criminal lawsuits. To be sure, the reservation of powers "vested in the courts of justice" is phrased as an exception from the prohibition of visitorial powers. But as we have just discussed, it cannot possibly be that, and it is explicable only as an attempt to make clear that the courts' ordinary powers of enforcing the law are not affected.

On a pragmatic level, the difference between visitation and law enforcement is clear. If a State chooses to pursue enforcement of its laws in court, then it is not exercising its power of visitation and will be treated like a litigant. An attorney general acting as a civil litigant must file a lawsuit, survive a motion to dismiss, endure the rules of procedure and discovery, and risk sanctions if his claim is frivolous or his discovery tactics abusive. Judges are trusted to prevent "fishing expeditions" or an undirected rummaging through bank books and records for evidence of some unknown wrongdoing. In New York, civil discovery is far more limited than the full range of "visitorial powers" that may be exercised by a sovereign. Courts may enter protective orders to prevent "unreasonable annoyance, expense, embarrassment, disadvantage, or other prejudice," A visitor, by contrast, may inspect books and records at any time for any or no reason.

The Comptroller's regulation, therefore, does not comport with the statute. Neither does the Comptroller's interpretation of its regulation, which differs from the text and must be discussed separately.

Evidently realizing that exclusion of state enforcement of all state laws against national banks is too extreme to be contemplated, the Comptroller sought to limit the sweep of its regulation by the following passage set forth in the agency's statement of basis and purpose in the Federal Register:

"What the case law does recognize is that 'states retain some power to regulate national banks in areas such as contracts, debt collection, acquisition and transfer of property, and taxation, zoning, criminal, and tort law.' [citing a Ninth Circuit case.] Application of these laws to national banks and their implementation by state authorities typically does not affect the content or extent of the Federally-authorized business of banking . . . but rather establishes the legal infrastructure that surrounds and supports the ability of national banks . . . to do business." 69 Fed. Reg. 1896 (2004) (footnote omitted).

This cannot be reconciled with the regulation's almost categorical prohibition in 12 CFR § 7.4000(a)(1) of "prosecuting enforcement actions." Nor can it be justified by the provision in subsection (a)(2)(iv) which defines visitorial powers to include "[e]nforcing compliance with any applicable . . . state laws concerning" "activities authorized or permitted pursuant to federal banking law," § 7.4000(a)(2)(iii). The latter phrase cannot be interpreted to include only distinctively banking activities (leaving the States free to enforce nonbanking state laws), because if it were so interpreted subsection (a)(2)(iii), which uses the same terminology, would limit the Comptroller's exclusive visitorial power of "regulation and supervision" to distinctively banking activities--which no one thinks is the case. Anyway, the National Bank Act does specifically authorize and permit activities that fall within what the statement of basis and purpose calls "the legal infrastructure that surrounds and supports the ability of national banks . . . to do business." See, e.g., 12 U.S.C. § 24 Third (power to make contracts); § 24 Seventh ("all such incidental powers as shall be necessary to carry on the business of banking"). And of course a distinction between "implementation" of "infrastructure" and judicial enforcement of other laws can be found nowhere within the text of the statute. This passage in the statement of basis and purpose, resting upon neither the text of the regulation nor the text of the statute, attempts to do what Congress declined to do: exempt national banks from all state banking laws, or at least state enforcement of those laws.

The dissent fails to persuade us. Its fundamental contention--that the exclusive grant of visitorial powers can be interpreted to preclude state enforcement of state laws--rests upon a logical fallacy. The dissent establishes,.. (and we do not at all contest), that in the course of exercising visitation powers the sovereign can compel compliance with the law. But it concludes from that that any sovereign attempt to compel compliance with the law can be deemed an exercise of the visitation power. That conclusion obviously does not follow. For example, in the course of exercising its visitation powers, the sovereign can assuredly compel a bank to honor obligations that are in default. Does that mean that the sovereign's taking the same action in executing a civil judgment for payment of those obligations can be considered an exercise of the visitation power? Of course not. Many things can be compelled through the visitation power that can be compelled through the exercise of other sovereign power as well. The critical question is not what is being compelled, but what sovereign power has been invoked to compel it. And the power to enforce the law exists separate and apart from the power of visitation.

The dissent argues that the Comptroller's expansive reading of "visitorial powers" does not intrude upon the, "'the historic police powers of the States,'".. because, like federal maritime law, federal involvement in this field dates to "'the earliest days of the Republic,'" ..For that reason, the dissent concludes, this case does not raise the sort of federalism concerns that prompt a presumption against pre-emption. We have not invoked the presumption against pre-emption, and think it unnecessary to do so in giving force to the plain terms of the National Bank Act. Neither, however, should the incursion that the Comptroller's regulation makes upon traditional state powers be minimized. Although the sovereign visitorial power of assuring national-bank compliance with all laws inhered in the Federal Government from the time of its creation of national banks, the Comptroller was not given authority to enforce non pre-empted state laws until 1966. .. A power first exercised during the lifetime of every current Justice is hardly involvement "from the earliest days of the Republic."

States, on the other hand, have always enforced their general laws against national banks--and have enforced their banking-related laws against national banks for at least 85 years, as evidenced by St. Louis, in which we upheld enforcement of a state anti-bank-branching law,

The dissent seeks to minimize the regulation's incursion upon state powers by claiming that the regulation does not "declare the pre-emptive scope of the [National Bank Act]" but merely "interpret[s] the term 'visitorial powers.'"... That is much too kind. It is not without reason that the regulation is contained within a subpart of the Comptroller's regulations on Bank Activities and Operations that is entitled "Preemption." The purpose and function of the statutory term "visitorial powers" is to define and thereby limit the category of action reserved to the Federal Government and forbidden to the States. Any interpretation of "visitorial powers" necessarily "declares the pre-emptive scope of the NBA," What is clear from logic is also clear in application: The regulation declares that "[s]tate officials may not . . . prosecut[e] enforcement actions." If that is not pre-emption, nothing is.

Applying the foregoing principles to this case is not difficult. "Visitorial powers" in the National Bank Act refers to a sovereign's supervisory powers over corporations. They include any form of administrative oversight that allows a sovereign to inspect books and records on demand, even if the process is mediated by a court through prerogative writs or similar means. The Comptroller reasonably interpreted this statutory term to include "conducting examinations [and] inspecting or requiring the production of books or records of national banks,"..when the State conducts those activities in its capacity as supervisor of corporations.

When, however, a state attorney general brings suit to enforce state law against a national bank, he is not acting in the role of sovereign-as-supervisor, but rather in the role of sovereign-as-law-enforcer. Such a lawsuit is not an exercise of "visitorial powers" and thus the Comptroller erred by extending the definition of "visitorial powers" to include "prosecuting enforcement actions" in state courts ..

The request for information in the present case was stated to be "in lieu of" other action; implicit was the threat that if the request was not voluntarily honored, that other action would be taken. All parties have assumed, and we agree, that if the threatened action would have been unlawful the request-cum-threat could be enjoined. Here the threatened action was not the bringing of a civil suit, or the obtaining of a judicial search warrant based on probable cause, but rather the Attorney General's issuance of subpoena on his own authority under New York Executive Law, which permits such subpoenas in connection with his investigation of "repeated fraudulent or illegal acts . . . in the carrying on, conducting or transaction of business." See N. Y. Exec. Law Ann. § 63(12) (West 2002). That is not the exercise of the power of law enforcement "vested in the courts of justice" which 12 U.S.C. § 484(a) exempts from

the ban on exercise of supervisory power.
Accordingly, the injunction below is affirmed as applied to the threatened issuance of executive subpoenas by the Attorney General for the State of New York, but vacated insofar as it prohibits the Attorney General from bringing judicial enforcement actions.

In 2004 Standard and Poor's suggested that the OCC's rules did not go far enough and that there remained some issues with some state predatory lending statutes:

...the OCC declined to exercise its perceived authority to occupy the field with regard to the real estate lending activities of National Banks. Instead, in the Rule, the OCC provides that "state laws that obstruct, impair, or condition a national bank's ability to fully exercise its federally authorized real estate lending powers do not apply to national banks." The Rule then lists examples of state laws that are and are not preempted by the Rule. Second, the Rule was silent on the issue of whether assignee liability provisions contained in state laws and regulations (including anti-predatory lending laws) apply to assignees of loans originated by National Banks..Finally, the Rule did not address the extent to which servicing restrictions in state anti-predatory lending laws could directly apply to purchasers or assignees of loans originated by National Banks.[34]

Do you think it is easy to distinguish between ways in which states can regulate national banks and ways in which they are pre-empted from regulating national banks?

Julie Williams of the OCC stated in a speech in 2004:

Our jurisdiction over national banks and their subsidiaries also does not deprive state regulators of a role in protecting consumers in their states, and we welcome the opportunity to work cooperatively with them to further that goal. We have invited state authorities to refer consumer complaints concerning national banks to the OCC, and to bring to our attention concerns that any national bank is engaged in unfair, deceptive, abusive or predatory practices. We have set up special procedures to handle and track referrals from state authorities.
The OCC and the states already cooperate extensively in many respects, referring consumer complaints to the appropriate regulator of the entity generating the complaint, and we welcome additional opportunities to collaborate. We issued a new Advisory Letter to national banks just last week clarifying our expectations about how they should handle consumer complaints that are forwarded to them from state agencies and departments. Personally, I hope that we can move beyond the rhetoric of the current controversy and leverage off existing cooperative processes to put our collective resources to work to

[34] Standard & Poor's Addresses OCC Rule Regarding Preemption of State Anti-Predatory Lending Laws, (3.3.04)

maximize their coverage.... Preemption provides benefits to banks and thrifts in the form of efficiencies that flow from uniform, consistent, and predictable standards that apply wherever in the nation an institution does business. In other words, you know you can run a better railroad if the track gauge doesn't change with every state and county line that you cross. But with preemption also comes responsibility, and this is a timely opportunity for all bankers to recommit to the highest standards of customer service, integrity, and fair play in their business. The *very best* way to counter the controversies that I have just discussed and preserve the benefits of preemption is for bankers to be leaders in responsible corporate behavior and exemplary customer treatment. That way, both bankers and their customers come out winners. [35]

The EU has similar issues about when Member States can impose general good rules on banks established in other states. The EU has adopted directives on banking which allow banks established in one Member State to offer services to customers in other Member States without the need to be established there. And EU banks established in one Member State can establish branches in other Member States. The directives limit Member States' ability to regulate banks established in other Member States, but Member States have had in place many rules (like the state predatory lending statutes in the US) that they want to apply to banks from other Member States. In 1997 the **EU Commission adopted a Communication on the "general good"** in the context of banking, which stated:[36]

The Commission published ... a draft communication which marked the launch of a broad consultation. Following the publication of this Communication, the Commission received numerous contributions from all the circles concerned (Member States, professional associations, credit institutions, consumer organizations, lawyers, etc.). It also organized hearings with all the parties who had taken part in the written consultation.
The Commission came to realize in the course of this consultation that there was still some uncertainty regarding the interpretation of basic concepts such as freedom to provide services and the interest of the general good. This uncertainty is such as to deter certain credit institutions from exercising the very freedoms which the Second Directive sets out to promote and, consequently, to hamper the free movement of banking services within the European Union.

---

[35] Julie L. Williams, Chief Counsel and First Senior Deputy Comptroller, Office of the Comptroller of the Currency, *National Banks and Uniform Standards*, Remarks to America's Community Bankers Government Affairs Conference (Mar.9, 2004) *available at* http://www.occ.gov/static/news-issuances/news-releases/2004/nr-occ-2004-18a.pdf.

[36] Commission Interpretative Communication, Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive, SEC (97) 1193, Jun. 20, 1997, at http://ec.europa.eu/internal_market/bank/docs/sec-1997-1193/sec-1997-1193_en.pdf.

The Commission therefore deems it desirable to restate in a Communication the principles laid down by the Court of Justice and to set out its position regarding the application of those principles to the specific problems raised by the Second Banking Directive. Its objective in publishing this Communication is to explain and clarify the Community rules. It provides all the parties concerned - national administrations, traders and consumers - with a reference document defining the legal framework within which, in the view of the Commission, banking activities benefiting from mutual recognition should be pursued.

In July 2003 the Commission suggested to Italy that its rules on usury infringed the Treaty:

In Italy, the Criminal Code stipulates usury as a crime, but it does not include a precise definition of what constitutes a usurious rate of interest. Such a definition was laid down in Law N° 108 of 7th March 1996. Decree-Law N° 394 of 29/12/2000, later converted into Law N° 24 of 24th February 2001, established that the nature of interest rates has to be assessed having regard to the time when the contract was signed. However, for fixed-rate loans pending at the end of 2000 interest rates cannot be higher than the average yield on national bonds (BTP) for the period 1996-2000. In practice, this means that the courts could consider as usurious interest rates of more than 9.96% per year, whereas at the time the 1996 law entered into force the normal rate on the market, was significantly higher, at 11%. This could have an impact on loans made by banks of other Member States that had been defined by the previous law as "non-usurious".

The effect of this measure, in the Commission's view, is to dissuade banks from other EU countries from offering their services in Italy. As such, the law violates the EC Treaty by constituting an unjustified restriction of the freedom to provide services (Article 49), the right of establishment (Article 43), and the free movement of capital (Article 56), as well as the Directive laying down Internal Market rules for banks (2000/12/EC).[37]

In 2006 the Commission announced that it was taking enforcement action against France in relation to a French rule which prohibited interest bearing current accounts:[38]

The European Commission has decided to ask France formally to amend its legislation ('Code Monétaire') that prohibits banks from offering interest on current accounts to their customers. The upshot of the legislation is that banks from another Member State which have a branch or subsidiary in France cannot offer banking services under the same conditions as in their home Member State. The Commission considers that the legislation is in breach of the EC Treaty rules on the freedom of

---

[37] EU Commission Press Release, Banking: Commission requests Italy to amend law on excessive interest rates (July 25, 2003).

[38] EU Commission Press Release, Banking: Commission calls on France to amend law on current account interest (Apr. 4, 2006).

establishment (Article 43) and does not correctly implement the Banking Directive's provisions on single licences. It has thus issued a reasoned opinion, this being the second stage of the infringement procedure laid down in Article 226 of the EC Treaty. In the absence of a satisfactory reply from France within two months of receiving the reasoned opinion, the Commission may decide to refer the matter to the European Court of Justice.

In 2008 France abolished the legal provisions that prohibited banks from paying interest on current accounts.[39]

The ECJ addressed these issues in a decision in 2004 in **Caixa Bank v France** that the Member States were prohibited under the EC treaty from restricting subsidiaries of banks established in other Member States from offering interest bearing "sight accounts" [40]:

7. It should be noted, as a preliminary point, that Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions (OJ 2000 L 126, p. 1) is not applicable in a case such as that at issue in the main proceedings, in particular because that directive does not refer to restrictions on the establishment of companies which, like Caixa-Bank, make use of freedom of establishment in a Member State as subsidiaries of credit institutions established in other Member States.
8. By its questions the national court essentially asks whether Article 43 EC precludes legislation of a Member State which prohibits a credit institution which is a subsidiary of a company from another Member State from remunerating sight accounts in euros opened by residents of the former Member State.
9. The freedom of establishment provided for in Article 43 EC, read in conjunction with Article 48 EC, is conferred both on natural persons who are nationals of a Member State and on legal persons within the meaning of Article 48 EC. Subject to the exceptions and conditions specified, it includes the right to take up and pursue all types of self-employed activity in the territory of any other Member State, to set up and manage undertakings, and to set up agencies, branches or subsidiaries...
10 The legal position of a company such as Caixa-Bank falls within the scope of Community law by virtue of the provisions of Article 43 EC.
11 Article 43 EC requires the elimination of restrictions on the freedom of establishment. All measures which prohibit, impede or render less attractive the exercise of that freedom must be regarded as such

[39] EU Commission Press Release, Banking: Commission closes case against France over law on current account interest (Apr. 3, 2008).

[40] http://www.bailii.org/eu/cases/EUECJ/2004/C44202.html

restrictions ...

12 A prohibition on the remuneration of sight accounts such as that laid down by the French legislation constitutes, for companies from Member States other than the French Republic, a serious obstacle to the pursuit of their activities via a subsidiary in the latter Member State, affecting their access to the market. That prohibition is therefore to be regarded as a restriction within the meaning of Article 43 EC.

13 That prohibition hinders credit institutions which are subsidiaries of foreign companies in raising capital from the public, by depriving them of the possibility of competing more effectively, by paying remuneration on sight accounts, with the credit institutions traditionally established in the Member State of establishment, which have an extensive network of branches and therefore greater opportunities than those subsidiaries for raising capital from the public.

14 Where credit institutions which are subsidiaries of foreign companies seek to enter the market of a Member State, competing by means of the rate of remuneration paid on sight accounts constitutes one of the most effective methods to that end. Access to the market by those establishments is thus made more difficult by such a prohibition.

15 While the French Government asserted at the hearing that there are forms of account comparable to sight accounts, such as 15-day accounts, which are not covered by the prohibition of remuneration and have helped credit institutions such as Caixa-Bank to compete with French credit institutions in raising funds from the public and increasing their market share in France, the Government conceded, however, that those accounts, unlike sight accounts, do not allow the use of bank cards or cheques. The prohibition at issue therefore entails a hindrance for credit institutions such as Caixa-Bank in their activity of raising capital from the public, which the existence of other forms of account with remunerated deposits cannot remedy.

16 The restriction on the pursuit and development of the activities of those subsidiaries resulting from the prohibition at issue is all the greater in that it is common ground that the taking of deposits from the public and the granting of credits represent the basic activities of credit institutions...

17 It is clear from settled case-law that where, as in the case at issue in the main proceedings, such a measure applies to any person or undertaking carrying on an activity in the territory of the host Member State, it may be justified where it serves overriding requirements relating to the public interest, is suitable for securing the attainment of the objective it pursues and does not go beyond what is necessary in order to attain it...

18 It must therefore be examined whether the grounds put forward by the French Government meet those criteria.

19 To justify the restriction on freedom of establishment resulting from the prohibition at issue, the French Government prayed in aid both the protection of consumers and the encouragement of medium and long-term saving.

20 It submits, first, that the prohibition at issue in the main proceedings is necessary for maintaining the provision of basic banking services without charge. Introducing remuneration for sight accounts would substantially increase the operating costs of banks, which, to recover those costs, would increase charges and introduce charges for the various banking services currently provided free, in particular the

issuing of cheques.
21 It must be observed, however, that while the protection of consumers is among the overriding requirements that can justify restrictions on a fundamental freedom guaranteed by the EC Treaty, the prohibition at issue in the main proceedings, even supposing that it ultimately presents certain benefits for the consumer, constitutes a measure which goes beyond what is necessary to attain that objective.
22 Even supposing that removing the prohibition of paying remuneration on sight accounts necessarily entails for consumers an increase in the cost of basic banking services or a charge for cheques, the possibility might be envisaged inter alia of allowing consumers to choose between an unremunerated sight account with certain basic banking services remaining free of charge and a remunerated sight account with the credit institution being able to make charges for banking services previously provided free, such as the issuing of cheques.
23 As regards, next, the French authorities' concern to encourage long-term saving, it must be observed that, while the prohibition of remuneration on sight accounts is indeed suitable for encouraging medium and long-term saving, it nevertheless remains a measure which goes beyond what is necessary to attain that objective.
24 In the light of the above considerations, the answer to the questions referred for a preliminary ruling must be that Article 43 EC precludes legislation of a Member State which prohibits a credit institution which is a subsidiary of a company from another Member State from remunerating sight accounts in euros opened by residents of the former Member State.

Should Italy's usury rules apply to loans to Italians in Italy? Should France be able to dictate the terms on which bank accounts may be offered in France?

CAPITAL ADEQUACY (INTRODUCTION)

1988 BASLE ACCORD
For internationally active banks, capital should equal at least 8% of risk weighted assets

Capital:
Tier 1 capital (equity and equity-like capital (perpetual non-cumulative preference shares and disclosed reserves (eg retained earnings)) - at least 4%
Tier 2 capital (hybrid (debt/equity) capital, loan loss reserves, subordinated debt) - maximum of 100% of Tier 1

Risk Weightings:
0% :(a) Cash; (b) Claims on central governments and central banks denominated in national currency and funded in that currency; (c) Other claims on OECD[41] central governments and central banks; (d) Claims collateralised by cash of OECD central-government securities or guaranteed by OECD central governments
0, 10, 20 or 50% (at national discretion): (a) Claims on domestic public-sector entities, excluding central government, and loans guaranteed by or collateralised by securities issued by such entities;
20% :(a) Claims on multilateral development banks and claims guaranteed by, or collateralised by securities issued by such banks; (b) Claims on banks incorporated in the OECD and claims guaranteed by OECD incorporated banks; (c) Claims on securities firms incorporated in the OECD subject to comparable supervisory and regulatory arrangements, including in particular risk-based capital requirements, and claims guaranteed by these securities firms; (d) Claims on banks incorporated in countries outside the OECD with a residual maturity of up to one year and claims with a residual maturity of up to one year guaranteed by banks incorporated in countries outside the OECD; (e) Claims on non-domestic OECD public-sector entities, excluding central government, and claims guaranteed by or collateralised by securities issued by such entities; (f) Cash items in process of collection
50% :(a) Loans fully secured by mortgage on residential property that is or will be occupied by the borrower or that is rented

---

[41] Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

100%: (a) Claims on the private sector (b) Claims on banks incorporated outside the OECD with a residual maturity of over one year; (c) Claims on central governments outside the OECD (unless denominated in national currency - and funded in that currency); (d) Claims on commercial companies owned by the public sector; (e) Premises, plant and equipment and other fixed assets; (f) Real estate and other investments (including non-consolidated investment participations in other companies); (g) Capital instruments issued by other banks (unless deducted from capital); (h) all other assets

Contingent Liabilities: credit conversion factors (which vary with the likelihood that the credit exposure will occur) are applied to determine credit equivalent amounts and these are then risk-weighted.

Weaknesses of the Accord:

- Risk weightings do not encourage banks to be careful about credit allocation, and are very rough
- The current rules favour OECD entities
- Valuation issues : "Minimum capital requirements for banks are of little use if the accounting conventions used to value banks' assets are flawed."[42]
- The rules may limit the amount of credit available, or at least affect who has access to credit
- The 1988 Accord only deals with credit risk (market risk has subsequently been addressed).
- Should financial innovation be driven by regulation rather than by customers' needs?
- There are doubts as to whether the Accord effectively harmonizes prudential rules because of the scope for interpretation of the requirements and possibilities of difference in application.

Basel II[43]

Basel II focuses on:

1. minimum capital requirements, which seek to refine the measurement framework set out in the 1988 Accord
2 supervisory review of an institution's capital adequacy and internal assessment process
3 market discipline through effective disclosure to encourage safe and sound banking practices

1. Minimum Capital Requirements

---

[42] Andrew Crockett

[43] http://www.bis.org/publ/bcbsca.htm .

Risk Weighting

A. Standardised Approach

More flexible approach to risk weighting using credit ratings where available.
For example: Loans to corporates are risk weighted at 100% if unrated. If rated, the risk weighting varies from 20% to 150% depending on the rating . However: “At national discretion, supervisory authorities may permit banks to risk weight all corporate claims at 100% without regard to external ratings. Where this discretion is exercised by the supervisor, it must ensure that banks apply a single consistent approach, i.e. either to use ratings wherever available or not at all. To prevent “cherry-picking” of external ratings, banks should obtain supervisory approval before utilising this option to risk weight all corporate claims at 100%.”

This might reduce credit for smaller businesses. The Accord provides for **regulatory retail portfolios** which would be risk-weighted at 75% (except for past due loans). These portfolios would include loan exposures to individuals and small businesses where individual exposures are limited and where the regulator is satisfied that the diversification justifies the 75% risk weighting.

Loans secured on residential property are weighted at 35% (but supervisors can increase based on local conditions) and loans secured on commercial real estate are weighted at 100%.

National regulators are responsible for recognising credit rating agencies (in the Accord these are referred to as **external credit assessment institutions** (ECAI)) on the basis of criteria relating to: objectivity, independence, international access/transparency, disclosure, resources and credibility.

The New Accord encourages banks to use credit risk mitigation techniques (to a greater extent than the 1988 Accord did) provided that the techniques meet standards of legal certainty:

> All documentation used in collateralised transactions and for documenting on balance sheet netting, guarantees and credit derivatives must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must have conducted sufficient legal review to verify this and have a well founded legal basis to reach this conclusion, and undertake such further review as necessary to ensure continuing enforceability.

B. Internal Ratings Based (IRB) Approach (for the largest banks which supervisors allow to use this approach)

The New Accord says: “Subject to certain minimum conditions and disclosure requirements, banks that have received supervisory approval to use the IRB approach may rely on their own internal estimates of risk components in determining the capital requirement for a given exposure. The risk components include measures of the **probability of default (PD), loss given default (LGD), the exposure at default (EAD), and effective maturity (M)**. In some cases, banks may be required to use a supervisory value as opposed to an internal estimate for one or more of the risk components.”

Banks are to identify their banking book exposures in a number of different categories of exposure with different risk characteristics (e.g. corporate exposures, sovereign exposures, bank exposures, retail exposures).

There are two versions of the IRB approach: the **Foundation** Approach and the **Advanced** Approach: “Under the foundation approach, as a general rule, banks provide their own estimates of PD and rely on supervisory estimates for other risk components. Under the advanced approach, banks provide more of their own estimates of PD, LGD and EAD, and their own calculation of M, subject to meeting minimum standards. For both the foundation and advanced approaches, banks must always use the risk-weight functions provided in this Framework for the purpose of deriving capital requirements.”

Operational Risk

The New Accord requires banks to have capital in respect of **operational risk**: “Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.”

2 Supervisory Review

This pillar emphasises that bank managements should develop internal capital assessment processes and that supervisors should assess how effectively they assess their capital needs. In addition, banks should think about risk management techniques other than capital. Under this pillar banks should particularly focus on aspects of risk that are not in fact or not entirely captured under the first pillar (eg credit concentration risk, business and strategic risk). Basle II says that supervisors should expect banks to operate with more than the minimum required amount of capital as a buffer.

3 Market Discipline

The market discipline pillar involves banks making detailed disclosures about the characteristics of their capital and how they assess capital adequacy in order to enable the market to assess the adequacy of their capital.

During 2009 the Basel Committee proposed changes to address issues with respect to capital requirements and securitization, flaws in risk management practices and disclosure to enhance market discipline. In September 2010 the Basel Committee announced agreement on Basel III:

Under the agreements reached today, the minimum requirement for common equity, the highest form of loss absorbing capital, will be raised from the current 2% level, before the application of regulatory adjustments, to 4.5% after the application of stricter adjustments. This will be phased in by 1 January 2015. The Tier 1 capital requirement, which includes common equity and other qualifying financial instruments based on stricter criteria, will increase from 4% to 6% over the same period.
The Group of Governors and Heads of Supervision also agreed that the capital conservation buffer above the regulatory minimum requirement be calibrated at 2.5% and be met with common equity, after the application of deductions. The purpose of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. While banks are allowed to draw on the buffer during such periods of stress, the closer their regulatory capital ratios approach the minimum requirement, the greater the constraints on earnings distributions. This framework will reinforce the objective of sound supervision and bank governance and address the collective action problem that has prevented some banks from curtailing distributions such as discretionary bonuses and high dividends, even in the face of deteriorating capital positions.
A countercyclical buffer within a range of 0% - 2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances. The purpose of the countercyclical buffer is to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth. For any given country, this buffer will only be in effect when there is excess credit growth that is resulting in a system wide build up of risk. The countercyclical buffer, when in effect, would be introduced as an extension of the conservation buffer range.
These capital requirements are supplemented by a non-risk-based leverage ratio that will serve as a backstop to the risk-based measures described above. In July, Governors and Heads of Supervision agreed to test a minimum Tier 1 leverage ratio of 3% during the parallel run period. Based on the results of the parallel run period, any final adjustments would be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration.
Systemically important banks should have loss absorbing capacity beyond the standards announced today and work continues on this issue in the Financial Stability Board and relevant Basel Committee work streams. The Basel Committee and the FSB are developing a well integrated approach to systemically important financial institutions which could include combinations of capital surcharges, contingent capital and bail-in debt. In addition, work is continuing to strengthen resolution regimes. The

Basel Committee also recently issued a consultative document Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability. Governors and Heads of Supervision endorse the aim to strengthen the loss absorbency of non-common Tier 1 and Tier 2 capital instruments.

Transition arrangements

Since the onset of the crisis, banks have already undertaken substantial efforts to raise their capital levels. However, preliminary results of the Committee's comprehensive quantitative impact study show that as of the end of 2009, large banks will need, in the aggregate, a significant amount of additional capital to meet these new requirements. Smaller banks, which are particularly important for lending to the SME sector, for the most part already meet these higher standards.

The Governors and Heads of Supervision also agreed on transitional arrangements for implementing the new standards. These will help ensure that the banking sector can meet the higher capital standards through reasonable earnings retention and capital raising, while still supporting lending to the economy. The transitional arrangements ... include:

National implementation by member countries will begin on 1 January 2013. Member countries must translate the rules into national laws and regulations before this date. As of 1 January 2013, banks will be required to meet the following new minimum requirements in relation to risk-weighted assets (RWAs):

o 3.5% common equity/RWAs;

o 4.5% Tier 1 capital/RWAs, and

o 8.0% total capital/RWAs.

The minimum common equity and Tier 1 requirements will be phased in between 1 January 2013 and 1 January 2015. On 1 January 2013, the minimum common equity requirement will rise from the current 2% level to 3.5%. The Tier 1 capital requirement will rise from 4% to 4.5%. On 1 January 2014, banks will have to meet a 4% minimum common equity requirement and a Tier 1 requirement of 5.5%. On 1 January 2015, banks will have to meet the 4.5% common equity and the 6% Tier 1 requirements. The total capital requirement remains at the existing level of 8.0% and so does not need to be phased in. The difference between the total capital requirement of 8.0% and the Tier 1 requirement can be met with Tier 2 and higher forms of capital.

* The regulatory adjustments (ie deductions and prudential filters), including amounts above the aggregate 15% limit for investments in financial institutions, mortgage servicing rights, and deferred tax assets from timing differences, would be fully deducted from common equity by 1 January 2018.

* In particular, the regulatory adjustments will begin at 20% of the required deductions from common equity on 1 January 2014, 40% on 1 January 2015, 60% on 1 January 2016, 80% on 1 January 2017, and reach 100% on 1 January 2018. During this transition period, the remainder not deducted from common equity will continue to be subject to existing national treatments.

* The capital conservation buffer will be phased in between 1 January 2016 and year end 2018 becoming fully effective on 1 January 2019. It will begin at 0.625% of RWAs on 1 January 2016 and increase each subsequent year by an additional 0.625 percentage points, to reach its final level of 2.5% of RWAs on 1 January 2019. Countries that experience excessive credit growth should consider accelerating the build up of the capital conservation buffer and the countercyclical buffer. National

authorities have the discretion to impose shorter transition periods and should do so where appropriate.

* Banks that already meet the minimum ratio requirement during the transition period but remain below the 7% common equity target (minimum plus conservation buffer) should maintain prudent earnings retention policies with a view to meeting the conservation buffer as soon as reasonably possible.

* Existing public sector capital injections will be grandfathered until 1 January 2018. Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital will be phased out over a 10 year horizon beginning 1 January 2013. Fixing the base at the nominal amount of such instruments outstanding on 1 January 2013, their recognition will be capped at 90% from 1 January 2013, with the cap reducing by 10 percentage points in each subsequent year. In addition, instruments with an incentive to be redeemed will be phased out at their effective maturity date.

* Capital instruments that no longer qualify as common equity Tier 1 will be excluded from common equity Tier 1 as of 1 January 2013. However, instruments meeting the following three conditions will be phased out over the same horizon described in the previous bullet point: (1) they are issued by a non-joint stock company 1 ; (2) they are treated as equity under the prevailing accounting standards; and (3) they receive unlimited recognition as part of Tier 1 capital under current national banking law.

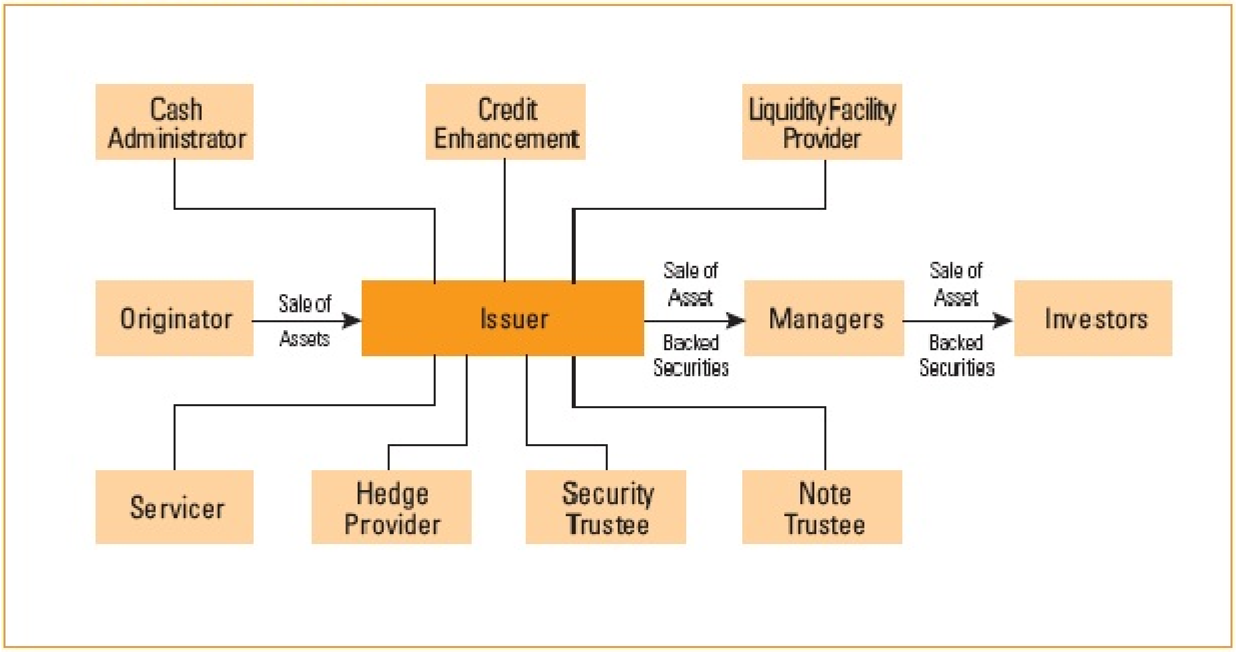
* Only those instruments issued before the date of this press release should qualify for the above transition arrangements.

Phase-in arrangements for the leverage ratio were announced in the 26 July 2010 press release of the Group of Governors and Heads of Supervision. That is, the supervisory monitoring period will commence 1 January 2011; the parallel run period will commence 1 January 2013 and run until 1 January 2017; and disclosure of the leverage ratio and its components will start 1 January 2015. Based on the results of the parallel run period, any final adjustments will be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration.

After an observation period beginning in 2011, the liquidity coverage ratio (LCR) will be introduced on 1 January 2015. The revised net stable funding ratio (NSFR) will move to a minimum standard by 1 January 2018. The Committee will put in place rigorous reporting processes to monitor the ratios during the transition period and will continue to review the implications of these standards for financial markets, credit extension and economic growth, addressing unintended consequences as necessary.

Typical Securitisation Structures

True Sale Securitisation

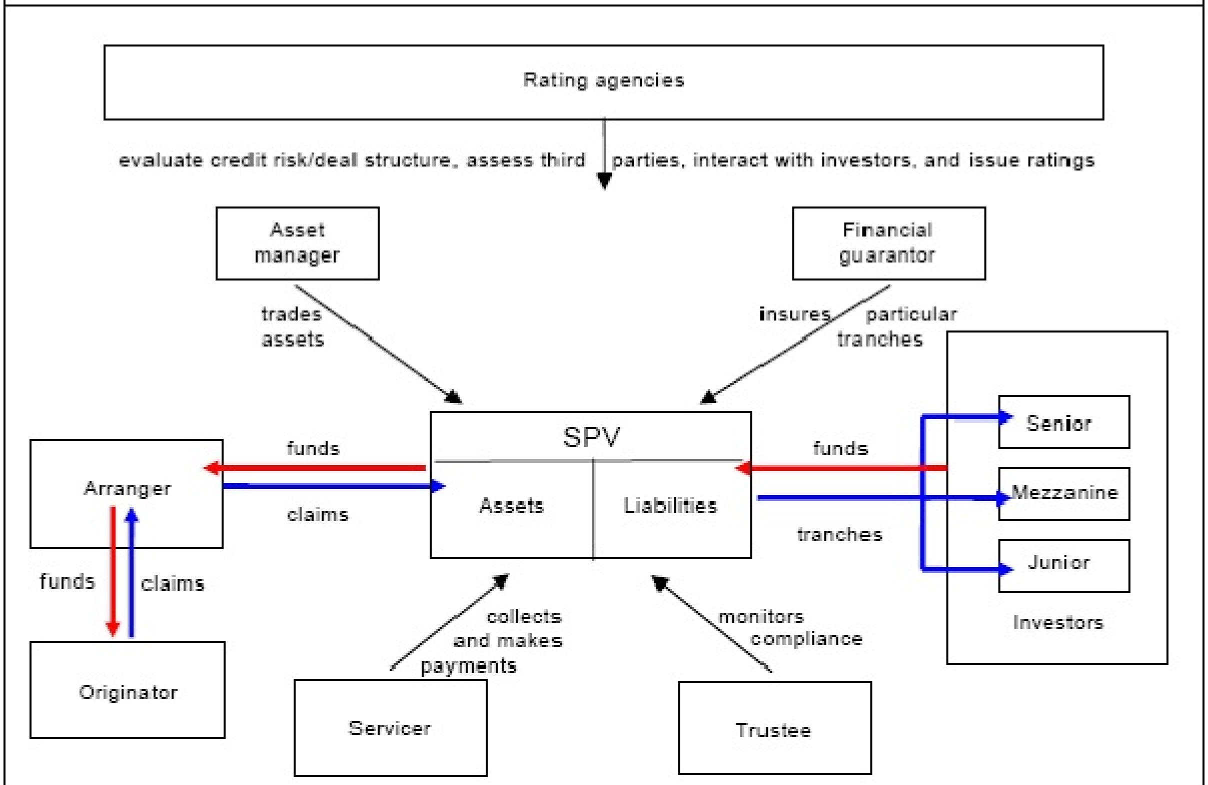


From: IFC, Securitization: Key Legal and Regulatory Issues, (2004)[44]

44 http://www.ifc.org/ifcext/eca.nsf/AttachmentsByTitle/Securitization1A%2B9-04/$FILE/Securitization1A%2B9-04.pdf

Structured finance: key market participants

Stylised overview of the "players" involved in (funded) structured finance transactions and of their roles



Source: CGFS (2005). Figure 1

From: Ingo Fender, Janet Mitchell, Structured Finance: Complexity, Risk and the Use of Ratings, BIS Quarterly Review, June 2005[45]

[45] http://www.bis.org/publ/qtrpdf/r_qt0506f.pdf