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THE INSTITUTIONAL FRAMEWORK FOR FINANCIAL MARKET POLICY IN THE USA SEEN FROM AN EU PERSPECTIVE

by Reinhard Petschnigg

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EXECUTIVE SUMMARY

In recent years, financial market integration has become a topical issue on the European agenda. Moreover, the importance of the institutional framework for the functioning of financial markets has generally been acknowledged. With a view to benefiting from the experiences of other countries, this paper takes a closer look at the institutional set-up of financial markets in the United States of America and investigates whether the US can serve as a model for the EU. For the purpose of this analysis, the institutional framework is defined as the organisational entities, procedures and practices of financial regulation and supervision, including issues such as competences and the distribution of powers.

The overall conclusion is that the US institutional set-up as a whole does not seem to be a suitable benchmark for the EU as it is the outcome of specific historical, political and economic circumstances, which differ substantially from those in the EU. Nevertheless, there are features which could provide inspiration for further debate on the EU institutional framework, such as the prominent role of federal regulatory agencies (including the central bank and its role as "umbrella supervisor" over financial holding companies), the capacity of the Office of the Comptroller of the Currency (OCC) as a federal institution to remove barriers to cross-border activities, and the elements of choice for the supervised entities in the regulatory system, which allow for some regulatory competition.

In analysing the US regulatory system and assessing it against the background of the EU setting, the following key messages emerge.

First, in the US, the level for the substantive regulation – federal or state level – as well as the "institutional density" is different for the various segments of the financial market. While banking and, in particular, the securities market are dominated by federal legislation and institutions, the regulation and supervision of the insurance business is left to individual states. By contrast, financial market legislation for all sectors is an integral part of the internal market competence of the European Union. Moreover, at the EU level, the Lamfalussy framework provides for procedures and institutional structures that are basically the same for banking, securities and insurance.

Second, the complex regulatory/supervisory structure in the US involves a number of federal regulatory agencies[1] alongside an estimated 100 state supervisory bodies which are responsible for the supervision of financial institutions and markets in the fifty states. The federal agencies are the outcome of a specific historical development of constitution/nation building (e.g. the Civil War) as well as the reaction by policy makers to profound economic shocks and crises (e.g. the Great Depression). The setting-up of these institutions implied a growing regulatory role for the federal level while the state agencies remained in place. This federal institution-building happened "top-down", with the states playing virtually no role in the process, as federal law in the US can be developed without the consent of the states. By contrast, there are no comparable federal regulatory agencies at European Union level. Instead, there is a framework for collective decision-making that builds upon the co-operation of Member States. This set-up is the result of the prior existence of strong nation states and the fact that the EU is not a federal state like the US. While this structure is probably the main factor that makes the EU level appear rather weak compared to the federal power in the US, it corresponds to the EU being a polity sui generis, where in many respects the Member States, as "masters of the Treaties", continue to play a dominant role.

1 e.g. the Office of the Comptroller of the Currency (OCC), the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC).

Third, the US federal agencies generally have great discretion in delivering policy encompassing legislative/regulatory, executive/supervisory and even judicial functions. This is a marked difference to the EU, where these functions are separated, with the EU level being competent for financial market legislation, and individual Member States – besides their participation in the rule-making process at EU level – having exclusive authority for implementation/supervision. Although under the Lamfalussy framework co-operation between the legislative/regulatory level and the executive/implementing level has been gaining momentum in the EU, it cannot match the integration of regulation and supervision that exists within the US federal agencies. However, while the US structures favour uniform implementation in the entities supervised by a particular regulatory agency, the high number of US regulatory agencies at the federal level makes the adoption of uniform rules across the same type of business (e.g. banking) a time-consuming and cumbersome process. If Congress, however, has a clear view on what it wants to achieve, it can threaten to legislate directly and thus speed up action by regulatory authorities. In the EU, the participation of Member States in rule-making risks slowing down the regulatory process as it requires compromise and often leads to the lowest common denominator. The Lamfalussy process tries to tackle this, among other things, by aiming at a clearer distinction between framework legislation to be decided at the political level and more technical rule-making by the so-called level II committees.

Fourth, the US system provides scope for "active" regulatory competition. In US banking, for example, both federal and state supervisors strive to offer high-quality supervision at a reasonable cost because banks may switch from a state to a "national" (i.e. federal) charter and vice versa. This element of choice does not exist in the EU. There is neither the possibility to switch to an "EU charter" and concomitant EU supervision (analogous to the national charter and OCC-supervision), nor the opportunity to decide upon "membership" in an NCB of the Eurosystem (analogous to membership in a Federal Reserve Bank), and thereby also making a decision on the regulator/supervisor at the "federal" level. Regulatory competition in the US is, however, constrained by federal law, which ultimately determines the leeway of regulatory agencies and state regulators. This can even be seen in an area such as insurance, where at present the federal level does not legislate. Under the threat of the introduction of federal regulation or of an optional federal insurance charter, US state insurance commissioners strive to co-operate effectively in order to allow smooth cross-border insurance activity.

With regard to the EU, it should be noted that, if properly applied, minimum harmonisation and mutual recognition provide room for regulatory competition among Member States, which may be induced by the mobility of financial intermediaries to transfer their headquarters from one Member State to another. This kind of "passive" regulatory competition can be regarded as a potential force for achieving a level playing field on the financial market.[2] The mutual recognition principle would, however, have to be applied in a much broader way than today. Currently, Member States still tend to protect intermediaries under their jurisdiction by imposing host country rules on intermediaries from other Member States.[3]

Fifth, the predominance of the federal level in the US system implies that barriers to cross-border business arising from state law may be easier to overcome than in the EU. While in US banking, the laws of the host state regarding community reinvestment[4], consumer protection, fair lending and the establishment

2 The new legal framework for the cross-border transfer of registered offices currently under preparation in the European Commission must be seen in this context.

3 In the consumer protection area, for example, Member States generally invoke the so-called "general good clause" to justify the continued application of host country rules.

4 The Community Reinvestment Act of 1977 is intended to encourage banks to extend credit to low and moderate-income neighbourhoods.

of *intra*state branches generally apply to *inter*state branches, the OCC may pre-empt the application of such state law to branches of national banks. In the EU, while there is the principle of primacy of EU law over national law, harmonised rules are not always implemented in a uniform fashion. Furthermore, as pointed out above, mutual recognition does not work in a satisfactory way.

Sixth, both in the US and in the EU, the multitude of regulators/supervisors puts a premium on co-operation. In the US, for the banking sector, the co-operation has been institutionalised at the federal level in the Federal Financial Institutions Examinations Council (FFIEC), established in 1979, and at the state level in the Conference of State Bank Supervisors (CSBS), which was founded as long ago as 1902.[5] The activities of the FFIEC and the CSBS concern, inter alia, the development of common reporting forms, the common training of officials or the accreditation of supervision programs. Furthermore, the CSBS played a decisive role in providing a basis for co-operative efforts among the state supervisors and as the natural interlocutor for discussion on supervisory agreements with federal agencies in view of liberalisation of interstate branching in the mid-nineties. As for the EU, the institutional co-operation among regulators/supervisors has gathered momentum with the introduction of the euro, increasing financial integration and the establishment of the Lamfalussy framework.

Seventh, the US experience shows how difficult it is to fundamentally change institutional set-ups. So far, such moves only happened under conditions of deep political transformation and/or major economic shocks. Once institutions have been set up, substantial inertia develops, making reform a daunting task. For example, recurrent efforts to streamline the banking supervisory system in the US have failed. The need for reform to remedy supposed or actual overlaps and regulatory conflicts by creating a single federal banking agency has not been convincing for Congress given the risks of changing the established structural features of the US financial system (dual banking system, regulatory role of the Fed) that such reforms would imply. While, so far, it has proved impossible to streamline the structure of supervision in the banking sector, the US has found a specific answer to an increasingly liberalised and de-specialised financial market by making the Federal Reserve responsible for umbrella supervision. Thus, incremental reform is feasible, while leaving the basic institutional structures intact and avoiding wide-ranging institutional overhaul.

Assuming a "path dependence" of institutional developments, a major shake-up of institutional structures in the EU or the delegation of regulatory competence to an EU regulatory agency would only occur in case of extraordinarily strong political or economic pressure. The European model of integration is, however, specifically characterised by incremental steps towards deeper integration. With the Lamfalussy process, the EU has provided itself with a framework that has the potential to foster viable European institutional structures for regulation and supervision. Consequently, a successful implementation of the Lamfalussy process that leads to better rule-making, and is supported by transparency, consultation and effective implementation through supervisory co-operation, would make sweeping institutional reform less likely. In the context of the Constitutional Treaty, the European Union level, while continuing to lack a substantial executive role in financial services might further strengthen its legislative role, since the Commission will be empowered to pass "delegated European regulations". In this regard, the EU framework may become even

5 In insurance, the National Association of Insurance Commissioners (NAIC) was founded even earlier, in 1871, to address the need to coordinate regulation of multi-state insurers. Co-operation among securities regulators takes place within the North American Securities Administrators Association (NASAA), founded in 1919.

more streamlined than that of the US as the regulatory function would be concentrated in a single entity. However, if the current EU approach does not meet expectations, new models might need to be devised.

1 INTRODUCTION AND OVERVIEW

In recent years, financial market integration has become a topical issue on the European agenda. Moreover, the importance of the institutional framework for the functioning of financial markets has generally been acknowledged. With a view to benefiting from the experiences of other countries, this paper takes a closer look at the institutional set-up of financial markets in the United States of America and investigates whether the US can serve as a model for the EU. For the purpose of this analysis, the institutional framework is defined as the organisational entities, procedures and practices of financial regulation and supervision[6], including issues such as competences and the distribution of powers.

This paper describes how the regulatory agencies came into being, what their nature is and how they relate to each other. A particular focus is on supervisory co-operation in US banking, against the background of banking deregulation in the second half of the 1990s, as well as efforts to consolidate the supervisory structure. Furthermore, light is shed on rule-making by regulatory agencies, with a particular emphasis on aspects of speed and flexibility. Regulatory competition and crises are identified as the main driving forces behind financial legislation and rule-making. References to the EU situation are made whenever appropriate. This paper does not, however, intend to provide a detailed description of the EU regulatory system. Throughout, the terms "federal/state level" are used for the US and "European Union (EU)/ Member State (MS) level" for the EU to depict the two main levels of governance.

2 INSTITUTION-BUILDING: THE REGULATORY AGENCIES

The institutional regime of the US financial system is characterised by a high institutional density, with both federal and state authorities responsible for financial sector regulation/ supervision. The Courts and the rule-making powers of Self Regulatory Organisations (SROs) such as the New York Stock Exchange also play an important role. There are, however, important differences between the regulatory and institutional framework for banking, insurance and the securities business.

As regards the regulation/supervision of the US banking system, on the federal level, there are four banking regulators, namely the Office of the Comptroller of the Currency/OCC (responsible for "national banks"), the Federal Reserve Board/FRB (responsible for state member banks, i.e. state banks that are members of one of the 12 Federal Reserve Banks, and acting as "umbrella supervisor" of bank/financial holding companies), the Federal Deposit Insurance Corporation/FDIC (responsible for state banks that are not members of one of the Federal Reserve Banks) and the Office of Thrift Supervision/ OTS (responsible for savings institutions)[7/8]. At the state level, fifty state banking agencies are responsible for the award of charters to those opting for state charter and state

6 Although it is understood that there is a conceptual difference between regulation and supervision, in the context of the description/analysis of the US system, the two terms will be used interchangeably in line with US terminology.

7 The OTS is the successor to the Federal Home Loan Bank Board, which was dissolved after the S&L-disaster. The OTS was established by Congress in 1989, as the primary Federal regulator of all Federal and state-chartered savings institutions across the nation that belong to the Savings Association Insurance Fund (SAIF) (which is under the control of the FDIC). The OTS headquarters are in Washington, D.C., but OTS staff – all in all about 900 – works out of local offices organised into five regions and examines and supervises savings institutions throughout the country. Its functions include issuing federal charters for savings and loan associations and savings banks; adopting and enforcing regulations to ensure that both federal and state-chartered thrift institutions operate in a safe and sound manner.

8 For the sake of completeness one should also include the National Credit Union Administration (NCUA), which supervises about 9,000 federal and state credit unions. Their total assets are about USD 600 billion, compared to USD 7,600 billion for the commercial banks and USD 1,200 billion for the thrifts. The NCUA was established in 1970 as the successor of the Bureau of Federal Credit Unions (set up in 1934).

supervision.[9] (See Annex I on the structure of banking regulation in the US).

At present, insurance regulation/supervision is exclusively done at the state level[10] with state insurance commissioners having direct regulatory authority. While there is no federal insurance agency, the National Association of Insurance Commissioners (NAIC) serves as the forum in which state commissioners co-operate to develop common policies where needed.[11]

By contrast, regulation of the securities business is almost exclusively done at the federal level and under the supervision of the Securities and Exchange Commission (SEC). Trading in equity and debt markets is supervised by the SEC[12], while the supervision of commodities and financial derivatives markets falls under the competence of the CFTC. State securities regulators basically restrict themselves to acting as service organisations (e.g. for dealing with complaints) to the investors who are resident in their state.

All in all, there are at least 110 financial regulatory authorities in the US, the bulk of which are state authorities.[13]

Given the number of actors involved as well as the varying competences at state and federal level, the current institutional framework governing the regulation and supervision of financial markets in the US is quite complex. It is the outcome of a specific historical developments in constitution/nation building, as well as the reaction by policy makers to profound economic shocks (e.g. the Great Depression, corporate scandals).[14] While the political institutions – Congress, Government, the Supreme Court – were set up shortly after the Revolutionary war under the US Constitution (1789), the federal monetary and financial agencies were only developed at a later stage, but again as a result of deep political and/or economic shocks: the Office of the Comptroller of the Currency (OCC) in the 1860s following the Civil War and a chaotic currency system, the Federal Reserve System (Fed) in 1913 after financial panics and bank failures, the Federal Deposit Insurance Corporation (FDIC) and the Securities and Exchange Commission (SEC) in 1933/1934 in the wake of the Great Depression. The creation of these institutions also entailed a strengthening of central government, i.e. a growing fiscal and regulatory role for the federation.[15]

9 Unlike the banking supervisory framework, which is based on a distribution of responsibilities to the federal and the state level, the authority to approve mergers and acquisitions of banking firms is assigned to the federal level. Depending on the transaction, the federal supervisory authority competent to rule on a merger or acquisition can be the: (i) the OCC; (ii) the Federal Reserve Board; (iii) the FDIC; or (iv) the OTS. The federal agencies which are in charge of anti-trust policies for the corporate sector, i.e. the Federal Trade Commission and the Department of Justice as well as the other banking supervisory authorities must be consulted before a decision is made.

10 When insurance companies operate under a Financial Holding Company (FCH), the "umbrella supervisor", i.e. the Fed, can, however, exert some influence over their prudential supervision.

11 The NAIC was founded in 1871 to address the need to coordinate regulation of multi-state insurers. It describes itself as a "multi-dimensional, regulatory support organization." State insurance commissioners have consistently rejected ideas for federal pre-emption or an optional federal charter, such as in banking.

12 The setting up of the Public Company Accounting Oversight Board (PCAOB) under the authority of the SEC by the Sarbanes-Oxley-Act of 2002 shows the increasing importance of the federal level also in the area of corporate law and governance, which traditionally has been under state competence.

13 According to the US Government Accountability Office (GAO), in July 2004, 23 states supervised banking and either insurance or securities in one agency. Fourteen states combined banking, insurance and securities regulation/supervision in a single agency. See GAO (2004), p. 72. The estimate for the total number of US regulatory agencies does not take into account the separate thrift and credit union supervisors in some states.

14 Calomiris (2000), p. xviii, referring to US banking regulations states that: "The history of US banking regulation repeatedly demonstrates the importance of transient events (economic 'shocks') for influencing long-term institutional history. That phenomenon – sometimes referred to as 'path dependence' – leads one to take an historical view of the evolution of regulation, that is, one that recognises that the *specific economic history* of a country matters. The long-run importance of shocks makes institutional change less predictable and less responsive to small changes in economic interests." See also Bebchuk/Roe (1999), pp. 127 - 170.

15 As Donahue and Pollak (2002), p. 85, put it "… the Civil War and reconstruction saw a marked shift of authority away from the states and toward the federal government. Prosecuting the war itself accelerated the growth of Washington's power …" and with regard to Franklin D. Roosevelt's New Deal: "An unprecedented degree of governmental activism on the economy, orchestrated from the centre, meant an unprecedented concentration of authority."

Interestingly, the US Constitution provides no explicit basis for the regulatory agencies, which nowadays figure so prominently in the US financial sector. Nevertheless, the Supreme Court – taking account of a rapidly changing economic and social environment – has allowed delegation of regulatory powers to independent agencies by acts of Congress under the condition that the legislature lays down "intelligible principles" with which the delegated body must comply when exercising discretionary power. The so-called "non-delegation doctrine", which claimed that Congress may under no circumstances sub-delegate its legislative prerogatives conferred to it by the Constitution, has thus been abandoned.

As for the European Union, the situation presents itself very differently. While having some important federal characteristics, the EU is not a federation, and it is an open question whether it will be one in the future. Moreover, the integration process – albeit motivated by the lessons of World War II – was not propelled by the sort of deep and fundamental crises the USA has experienced in its much longer history. It is, therefore, not surprising that, in the EU, integration has proceeded more gradually, with Member States playing an important role in the decision-making process and EU structures being relatively "light". The institutional structure for financial regulation and supervision at the EU level as redesigned under the Lamfalussy framework (see Annex II), has thus built on existing structures in the Member States. Furthermore, it has been established in a proactive manner after a thorough discussion involving national governments in the ECOFIN (and in its preparatory bodies), the European Commission, the European Parliament (EP) and the ECB, eventually resulting in a much clearer structure than that in the US, where institutional development occurred in a more haphazard way. (For a highly stylised comparative presentation of regulatory structures see Annex III).

In the EU, the creation of US-style regulatory agencies has not been an option because the prevailing consensus reflected in the so-called "Meroni doctrine" has been and still is that agencies with discretionary regulatory powers need to be explicitly set up by the Treaty. The Meroni doctrine was developed by the European Court of Justice[16] and implies that EU institutions cannot delegate discretionary regulatory powers which have been conferred on them by the Treaty to outside bodies as this would threaten the balance of powers between the institutions.[17] A sub-delegation of regulatory powers exercised by any of the Community institutions to an independent agency would, therefore, require explicit authorisation by the Treaty.

This is in line with current mainstream thinking that the original source of legitimacy of EU action lies with the Member States which, as "masters of the Treaty", must unanimously agree on a delegation of competences.[18] In this way, the constitutions of the Member States and their sovereign powers are effectively preserved and protected. By contrast, in the US, the source of legitimacy of the federation is primarily derived from the citizens exercising their sovereign power via their elected representatives in the US Congress.[19] In the

16 See Meroni e Co., Industrie Metallurgiche, SpA v. High Authority. Cases 9 and 10/56. ECR 11-48, 53-86. ECJ 1958. The High Authority was the precursor to the Commission under the European Coal and Steel Community Treaty.

17 The delegation of powers to outside bodies is to be seen distinctly from the delegation of implementing powers by the Council to the Commission under the so-called "comitology" upon which the Lamfalussy framework is built. "Comitology" is explicitly authorised by the Treaty (Art. 202).

18 However, the EU also has elements of a Union of citizens, notably reflected in the direct election of the Member of the EP and in the EP's role as a co-legislator but also in Art. I-1 of the Constitutional Treaty on the Establishment of the Union referring to "… the will of the *citizens* and States of Europe to build a common future …. "

19 The US Constitution as adopted by the Constitutional Convention in Philadelphia in 1787 had to be ratified by 9 of the 13 original states to enter into force. Any change to the Constitution needs to be ratified by three fourths of the states. In the EU, any change to the Treaty requires an Intergovernmental Conference and ratification by all Member States.

US, both legislative chambers, the House of Representatives and the Senate, are directly elected.[20] The senators thus neither act on behalf of their state government, nor of their state legislature.[21] When a law is about to be passed by Congress or a rule is being adopted by a regulatory agency, state governments, during the rule-making process, from a legal point of view, may present their interests like any other interested external party.[22] By contrast, in the EU, Member States advance their interests by directly participating in rule-making both with regard to the broad framework (Council acting in co-decision with the EP) and the spelling out of the legislative details (in the financial markets field via the committees under the Lamfalussy framework (see Annex II)). Furthermore, the European Commission has to rely on the Member States and their administrations to implement legislation, while in the US the federal regulatory power is backed by a sufficient financial and administrative capacity to directly implement rules and to supervise their application.[23]

In the EU, although there are no US style regulatory agencies, there are currently 16 agencies – none of them in the financial services field[24] – that were established from the beginning of the 1970s with a view to fulfilling specific tasks without, however, disposing of regulatory powers.[25] As the environment in which the institutions operate has changed from the time of the mid-1950s when the Meroni-doctrine was established, some observers argue that it is time to reconsider the Meroni doctrine and to adapt it in a pragmatic way[26] thereby coming closer to the US practice as it has developed over time.

If EU regulatory agencies were to be established, they would have to be subject to similar accountability mechanisms as those in

20 The population of each of the fifty states elects two senators. Being elected for a longer term than the House members (6 years vs. 2 years), senators are supposed to think/act with a longer time horizon and to provide a filter to "to short-term passions of public opinion", which might have more influence on the House of Representatives, see http://usgovinfo.about.com (Why We Have a House and a Senate).

21 Even prior to the Seventeenth Amendment to the US Constitution of 1913, when US senators were appointed by the State legislatures, senators were less closely linked to their respective State governments than are the members of the EU Council or of the German Bundesrat. For example, senators were not subject to recall by the State legislatures that appointed them, did not have to develop a joint position on behalf of their State, and were not officially members of State governments when they came to Washington. See Halberstam (2002), p. 237.

22 While in the US federal regulators have gained prominence with more regulation on the federal level, in the EU – besides the Commission – it is the Member States regulators/supervisors that have increased their importance. More generally, regulators from Member States have over the recent decades learned to work together in a "new pattern of regulatory federalism based on partnership and networking". This has even led to new and converging regulatory structures on the MS level (see Majone (2002), p. 254). Moreover, the regulatory dialogue taking place with third countries implies representation on the EU-side by the Commission and the chairpersons of the level III committees (see Annex IV).

23 The four federal banking agencies alone employ altogether about 12,000 staff (regulation, supervision and supporting staff), while the European Commission employs 110 staff that are responsible for the whole financial sector. So far, the focus of the staff concerned with financial institutions and markets in DG MARKT has been primarily to develop proposals for binding and non-binding rules in the context of the Financial Services Action Plan (FSAP) and to – selectively – monitor implementation by Member States.

24 The ECB, by virtue of the Treaty, has regulatory powers in the fields of monetary policy, statistics and payments systems, and can be authorised by the Council to perform "specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings." (Art. 105/6).

25 These tasks comprise monitoring of the environment (e.g. the European Environment Agency), fostering co-operation in terms of vocational training (e.g. European Centre for the Development of Vocational Training), or authorising the release of products into commercial circulation (e.g. the European Agency for the Evaluation of Medicinal Products). It is noteworthy that with regard to some of the agencies which were established more recently, some Commission services wanted to provide them with discretionary regulatory powers. The Commission's Legal Service, however, objected on grounds of the Meroni doctrine. Arguably, the Legal Service later moved away somewhat from its position by stating that agencies cannot exercise "regulatory powers of *general* character", allowing the conclusion – a contrario – that these bodies can exercise *specific* regulatory powers. See Yataganas (2001), Afterword.

26 They point especially to changes such as deregulation in important sectors of the common market, e.g. telecommunications, electricity, which make independent European regulators more necessary than ever, but also to the increasing importance of the EP being the expression of a Union of citizens complementing the Union of Member States, which would make the traditional doctrine appear less convincing. See Yataganas (2001) or Pelkmans/Casey (2003), p. 19.

the US, where congressional oversight[27], administrative procedures prescribed by law[28] and courts keep regulatory discretion in check.

To some extent, the regulatory action of the Commission may be compared to that of the US regulatory agencies. Reflecting the dominant role of Member States in the EU, the Commission's regulatory action under the Lamfalussy framework is kept in check primarily by the Member States in the regulatory committees (i.e. the level II committees) and to a lesser extent by the EP. Although under the Lamfalussy framework the Commission has assumed obligations in terms of consultation and transparency vis-à-vis the EP and third parties, pursuant to the current Treaty and comitology rules, the EP still only has the right to be informed and to give its opinion,[29] but cannot call back a regulation passed by the Commission.[30/31]

Below, some important US agencies dealing with the regulation and supervision of financial markets (the OCC, the Federal Reserve System, the FDIC, and the SEC) will be briefly described, touching upon their specific origins, tasks and competences. Furthermore, given the importance of the OCC in creating a unified financial services market, a case study of a recent rule-making by the OCC will be presented.

3 REGULATORY AGENCIES: OCC, FED, FDIC, SEC

THE OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC)[32] AND THE DUAL BANKING SYSTEM

The OCC is the oldest of the federal bank regulatory agencies, established by the National Currency Act of 1863 and strengthened by the National Bank Act of 1864. Based on legislation elaborated by the Lincoln Administration, the OCC was designed as part of a new banking system to be made up of many separate, federally chartered and privately

27 Congressional oversight includes hearings in congressional committees on a regular basis and powers to reject or to change a specific agency rule, to change the remit of the agency or, furthermore, to dismiss a head of agency in case serious misconduct.

28 Before the enactment of the Administrative Procedure Act (APA), in 1946, many US agencies paid little attention to procedural matters. The New Deal trusted that technical and scientific expertise would – by definition – exclude regulatory discretion becoming a problem. Judicial review of the evidence used in reaching a decision was even seen as a serious threat to "the very virtue of specialized knowledge which constitutes one of the chief justifications for the establishment of [regulatory] commissions" (Fainsod M. (1940), "Some Reflections on the Nature of the Regulatory Process", quoted in Majone (2002), p. 258). With the APA and later legislation, such as the Freedom of Information Act (1974) and the Government in the Sunshine Act (1976), a uniform framework for the conduct of agency activities and minimum standards of consultation and transparency were laid down. They effectively codified techniques developed by courts to limit the exercise of regulatory discretion, e.g. disclosure for comment, clear statement of legislative intent, and most importantly, giving reasons for their decisions. See Majone (2002), p. 265.

29 In 2002, the Commission committed, however, to "take the utmost account of the Parliament's position" (see declaration of President Prodi before the EP plenary on 5 February 2002). This commitment was preceded by a flexing of muscles by the EP which implicitly threatened to block or to delay legislation to be passed under co-decision. Moreover, the securities Directives adopted under the Lamfalussy framework contain a sunset clause, which means that the delegation of implementing measures to the Commission will expire after four years following their entry into force unless renewed prior to the expiry date under the co-decision procedure (see Inter-Institutional Monitoring Group – Third Report Monitoring the Lamfalussy Process (2004), p. 8)

30 With the entry into force of the Constitutional Treaty, the EP, like the Council, would have a call back right as regards "delegated European regulations" passed by the Commission. This would, however, be a two-edged sword, as technical rule-making might be subject to a politicisation through lobbying directed at the EP. In the US, the regulatory discretion of agencies is probably less directly influenced by lobbying and "political" consideration with the expertise and independence of their officials acting as a filter.

31 The assessment that the accountability in the EU is relatively weak compared to the US does not change when one acknowledges the fact that the activities of level III committees, i.e. the committees of supervisors, are scrutinised during regular hearings in the EP. It is furthermore recalled that the level III committees do not have regulatory powers. Rather their activities are limited to giving advice to the Commission and facilitating supervisory convergence.

32 The OCC is an autonomous bureau of the Treasury Department and is headed by a single person – the so-called Comptroller of the Currency, who is appointed by the President for a five-year term and also serves as a director of the FDIC. The OCC's headquarters is in Washington D.C., it has four District offices, plus a "Large Bank office" and a "Mid-size/Credit Card Banks office". Around 2,800 employees work for the OCC, the vast majority of whom are bank examiners. The Treasury officials cannot involve themselves in case-specific matters before the Comptroller (such as examinations, enforcement proceedings etc). Furthermore, it cannot block or delay OCC regulations. The OCC funds itself from fees paid by national banks. See Macey/Miller/Carnell (2001), p. 70.

owned banks – the so-called national banks – that would be established throughout the country. Wherever located, they would operate under a uniform set of federal powers, under federal standards of operation, and federally mandated capitalisation, with a federal supervisor – the OCC – exercising the oversight function. The national bank system was to provide the federal government with a vital source of funds to finance inter alia the Civil War. At the same time, the banknotes issued by the banks with the Comptroller's approval were intended to be the first national currency.[33]

Originally, national banks had been expected to crowd out the existing state banks completely, not least because the federal level actively discriminated against them by taxing banknote issuances by state banks. State banks, however, survived as demand deposits were becoming a much more important part of banking compared to the power to issue banknotes. In this way, the so-called dual banking system consisting of state banks[34] and the national banks came into being, with the OCC having authority over national banks[35].

One of the defining characteristics of the dual banking system is the OCC's nationwide jurisdiction over federally chartered banks. The OCC's right of pre-emption of state laws is based on a Supreme Court's decision (M'Culloch v. Maryland, 1819) stating that "states have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control" national bank's ability to exercise business activities authorised under federal law. Whenever the OCC designates a state regulation as a "significant interference" with federal prerogatives, the Supreme Court normally follows the OCC and upholds pre-emption. The origins of pre-emption[36] are well described by Greve:

> "Congress was clear-eyed about its objectives: it wanted to create national banks as instruments for a national economy and currency. The events of that time gave Congress a vivid sense of the states' centrifugal tendencies (to put it gently). And so Congress readily concluded that national banks needed a total prohibition against state regulation. A federal charter is not a pre-emptive floor, above which states are still permitted to regulate. Rather, it truly excludes any state law that materially affects the operation of national banks."[37]

This does not mean, however, that federally chartered institutions are not subject to state laws. When there is no conflict between federal law (e.g. the National Bank Act) and state law, the latter is also applied. If there is a conflict, the OCC may use its pre-emptive power. [38]

An important basis for the OCC's powers lies furthermore in the Supreme Court's decision[39] according to which the "business of banking" is not limited to the enumerated powers (of banks) in the National Bank Act and the OCC has discretion to authorise activities beyond those specifically mentioned.

33 As such, the national bank system was part of a national program of economic development, which can be traced back to the so-called "American system" of mid-1800, which constituted a "visionary program of national economic development that included federal construction of interstate turnpikes and canals, federal funding for other internal improvements, … and a national bank". See Comptroller of the Currency (2003), p. 6.

34 About three out of four commercial banks currently operate under a state charter. Nine of the top ten banks, however, operate under a national charter (see Annex III).

35 In simple terms, the OCC charters, regulates and supervises. It can, inter alia, revoke charters, remove bank officials or impose fines. The OCC supervises approximately 2,100 institutions, i.e. approximately one quarter of all commercial banks, among them the largest US-banks.

36 The term "pre-emption" is used in US legal language, inter alia, with regard to the specific powers of the OCC, but also in the general context of the relationship between the federal and the state level.

37 See Greve (2003) p. 12.

38 The Supremacy Clause of the US Constitution says that the "Constitution and the laws of the United States … shall be the supreme law of the land … anything in the constitutions or laws of any State to the contrary notwithstanding." This means that any federal law – even a regulation of a federal agency – supersedes any conflicting state law. When Congress is not clear about its will to pre-empt state law, it is the Court's task to look beyond the express language of federal statutes. See http://www.law.umkc.edu/faculty/projects/ftrials/conlaw/preemption.htm

39 Nations Bank of North Carolina v. Variable Annuity Life Ins. Co., 513 US 251 (1995), quoted in Comptroller of the Currency (2003), p. 14.

THE FEDERAL RESERVE SYSTEM[40] AND "UMBRELLA SUPERVISION"

In 1913, after recurrent banking crises, which were exacerbated by the lack of an outside source of reserves for the banking system (which the OCC could not provide), Congress passed the Federal Reserve Act. The Federal Reserve Act instituted the Federal Reserve System, headed by a Board of seven members. To ease concerns regarding excessive centralisation, Congress arranged for Federal Reserve Banks to be established in twelve districts.

For national banks, membership in the Federal Reserve System was and is mandatory, while for state banks it is optional. As the Federal Reserve System was given the authority to supervise and examine member banks, there was an overlap with the OCC, which had authority over the national banks. This was settled in 1917, when it was agreed that the OCC would supervise national banks, but would also provide its reports to the Federal Reserve, while the Federal Reserve would supervise state member banks. As a consequence, the Fed today directly supervises approximately 1,000 state banks out of roughly 8,000 (state and national) commercial banks (see Annex I).[41]

In the wake of the Great Depression, more powers were given to the Board within the Federal Reserve System under the Banking Act of 1935. The new legislation strengthened the Board's administrative responsibility for Reserve Bank supervisory duties, and also established the Federal Open Market Committee (FOMC) to decide upon open market operations.[42] At the same time, the US Treasury Secretary and the Comptroller of the Currency were removed from the Fed's Board.

During the post-war period, the Federal Reserve System was further strengthened, first by the Bank Holding Company Act in 1956, which placed the formation of multi-bank holding companies and their acquisition of banking and non-banking interests under the control of the Federal Reserve,[43] and later with the Financial Services Modernization Act of November 12 1999, the so-called Gramm-Leach-Bliley Act (GLBA). The GLBA repealed the parts of the Bank Holding Company Act which separated commercial banking from the insurance business, as well as the parts of the Banking Act of 1933 that separated commercial banking from the securities business (also known as "Glass-Steagall"). The new financial holding companies were placed under the authority of the Federal Reserve System which retained all the power it had under the Bank Holding Company Act.[44] Consequently, for financial holding companies, the Fed either reviews or receives notification of their formation and subsequent expansion plans, and is also responsible for supervising the overall banking structure. The Fed thus gains insight into the operations of banks which are not directly under its supervision. All in all, the Fed supervises about 640 financial holding companies, the fifty largest of which have total consolidated assets of about USD 7,600 billion, well above the total assets of USD 5,500 billion of the fifty largest US commercial banks taken together. (The primary supervisors of the top 50 US banks are shown in Annex IV).

40 The Federal Reserve System consists of the Board of Governors and the 12 Federal Reserve Banks. The Board of Governors is located in Washington D.C. Its members are nominated for 14 years (except for the Chairman whose term is 4 years, renewable) and are independent. It has approximately 1,900 employees (approximately 370 of which are in supervision). While the Board determines bank supervision policy, it generally delegates the task of conducting the examinations to the 12 Reserve Banks (altogether about 2,600 staff in supervision, 1,200 of which are field examiners).

41 In terms of total assets, however, the Fed directly supervises only some 10% of the commercial banking sector as two of the largest US banks, JP Morgan Chase and HSBC, have been changing their charter from a state to the national charter.

42 See Spong (2000), pp. 21 and 24.

43 Non-banking interests had to be closely related to banking.

44 See Barth, Brumbaugh and Wilcox (2000). GLBA removed the restrictions on affiliations between banks and securities firms, but banks and securities firms each continue to be prohibited from engaging directly in the other industry's core activities.

The Gramm-Leach-Bliley Act was designed to establish a system of functional regulation[45] by allowing each entity in a financial holding company to be regulated by its primary supervisor at the state or federal level. In exercising its function as "umbrella supervisor", the Federal Reserve Board must rely primarily on the functional regulators to supervise the individual affiliates.[46] The GLBA requires the Fed to use "to the fullest extent possible" the reports and examinations of (i) other supervisors, including appropriate state and federal authorities, for banks and thrifts, (ii) the SEC for registered securities brokers, dealers, or investment advisers, and (iii) state insurance commissioners for licensed insurance companies. Although the Federal Reserve may examine a financial subsidiary only under certain conditions,[47] it may well be that the Fed uses its umbrella authority quite extensively given its view of its own mission. This encompasses responsibility for the stability of financial markets as a whole and not only of banks. It also includes crisis management such as in the cases of Penn Central (1970) or LTCM (1998). In theory, the Fed's role as umbrella supervisor may be limited by the possibility of national banks to diversify via subsidiaries into most financial activities (although not insurance underwriting, merchant banking or real estate) thereby avoiding the use of a financial holding company structure and, in turn, oversight by the Fed.[48] However, from a practical perspective, it would be hard for all but the smallest national banks to avoid creating holding companies, since the holding company is the preferred vehicle to access US stock and bond markets.

Since the mid-1980s the Federal Reserve Board, under the leadership of Chairman Alan Greenspan has became one of the main driving forces behind regulatory reform, giving banks more freedom to act in a highly geographically and functionally-restricted environment. Under competitive pressures from both outside and inside the US, the case for liberalising banking regulation has become more and more compelling. During this process, the Fed has become an increasingly powerful regulator[49] as the arguments for having an umbrella supervisor in an increasingly liberalised financial market – both in functional and geographical terms – have become ever more convincing.

45 Functional regulation, which is a securities law concept that hinges on the definition of the product to be supervised and not on the definition of the institution concerned, was, however, impossible to achieve as banking law rests primarily on the definition of banking institution and the combination of its activities (accepting deposits and making loans) and not on the individual products a bank sells. Thus, banking regulation by definition constitutes institutional regulation. See Schooner (2002), pp 190f. The reference to functional regulation was inspired by the objective to streamline regulation and to avoid regulatory overlaps. Given increasing product hybridisation, regulatory specialisation and clear attribution of roles is, however, difficult to achieve. See Garten (2002), p. 168.

46 See Spong (2000), p. 266.

47 These conditions are: Firstly, the subsidiary is believed to be engaged in activities posing a material risk to affiliated financial institutions; secondly, an examination is necessary to assess risk management systems, or, thirdly, there is reasonable cause to believe a subsidiary is not in compliance with the Bank Holding Company Act or other laws enforced by the Fed. The Fed may not set capital requirement for functionally regulated subsidiaries that are already in compliance with the capital standards of their primary supervisor. Neither may the Fed require such subsidiaries to assist affiliated depository institutions if that would materially harm their own condition. See Spong (2000), p. 48f.

48 See Garten (2002), p. 174.

49 As a bank regulator, the Federal Reserve establishes standards designed to ensure the safe and sound operation of financial institutions. These standards may take the form of regulations, rules, policy guidelines, or supervisory interpretations and may be established under specific provisions of law "or under more general legal authority". See Federal Reserve-Website http://www.federalreserve.gov/pf/pdf/frspf5.pdf Supervision and Regulation, p. 80. For some, the Fed has become "a probably too powerful regulator". They refer to a potential conflict with its monetary policy role. Furthermore, they criticise the power of the Fed to decide what a "financial activity" is, thereby defining the scope of their supervisory authority. See Calomiris (2002), p. 22.

THE FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)[50]: A COMPONENT OF THE FEDERAL SAFETY NET

A further significant institutional change concerning regulation and supervision was the creation in 1933 of the Federal Deposit Insurance Corporation (FDIC), which also formed part of the restrictive legislation passed in response to the Great Depression. The FDIC's mission is to maintain public confidence in the US financial system by insuring deposits for up to USD 100,000, identifying, monitoring and addressing risks to the deposit insurance funds[51], and limiting the effect on the economy and the financial system when an institution fails. Insurance is mandatory for all Fed member banks, but open to non-member banks upon approval by the FDIC. The FDIC as a fully-fledged banking regulator is empowered to examine all insured banks. To exclude supervisory duplication with the Federal Reserve and the OCC, supervision by the FDIC has been largely confined to those insured state banks that are not members of one of the Federal Reserve Banks, the so called "state non-member banks" (today numbering approximately 5,300).[52] The role of the FDIC is important in the process of bank chartering at state level. In fact, many states require state-chartered banks to obtain FDIC insurance before they begin to operate.[53]

In an effort to reduce moral hazard in the aftermath of the Savings and Loan crisis in the 1980s, federal deposit insurance was radically changed in 1991 with the enactment of the Federal Deposit Insurance Incorporation Improvement Act (FDICIA). Prior to the 1991 legislation, the fees on the insured banks ("assessments") that funded the FDIC were subject to an upper limit, with the federal government having to step in to prevent depletion of the resources of the FDIC.[54] Following the enactment of the FDICIA, the risk of losses was placed on insured banks rather than on the federal government. This was achieved by authorising the FDIC to impose special assessments on insured institutions and to use the money to repay temporary bridging loans made by the Treasury to the FDIC. The granting of such Treasury loans is conditional on the FDIC being in a position to demonstrate that its income from assessments will be sufficient to service and repay the loan.

The creation of the FDIC as part of the federal safety net (together with the lender-of-last-resort facilities by the Fed and its guarantee of daylight overdraft for large-dollar inter-bank transfers on Fedwire) meant that the federal level assumed increasing responsibility for the regulation and supervision of the banking sector. Federal deposit insurance as such was therefore instrumental for an intensification of federal regulation and supervision over banking. As Macey puts it,

> "… the history of the dual banking system since 1933 has been a steady relentless march towards federal regulation of all aspects of banking related to safety and soundness. This, of course, means that there has been a steady march towards federal pre-emption in all important aspects of banking regulation. These areas include the regulation of minimum capital requirements for banks, the regulation of reserve requirements for deposits, and the allocation

50 The FDIC is an independent agency managed by five directors, one of whom is the Comptroller of the Currency and one is the Director of the Office of Thrift Supervision. The three others are appointed by the President subject to approval by the Senate, one of them being appointed as the Chairman for a period of 5 years (the other two directors are appointed for a period of 6 years). The main office of the FDIC is in Washington D.C. Moreover, it has six regional supervisory offices and a number of field offices around the country. It employs about 5,200 people. Like the Fed and the OCC, the FDIC is a permanent member of the Basel Committee.

51 A reform of the deposit insurance system is currently pending in Congress. Among other things, it is proposed to merge the insurance funds (for banks and thrifts) and to increase insurance coverage.

52 Since 1983 the FDIC has participated in the examination of certain problem banks not directly under its supervision. In order to eliminate redundant examinations, the FDIC's current policy is to participate in the examination of banks supervised by other agencies only when the examinations represent a concurrent effort or are confined to special circumstances; see Spong (2000), p. 56.

53 See Spong (2000), p. 150.

54 See Kaufman/Wallison (2001), p. 33.

of regulatory authority over the bank closure decisions. All of these areas once were subject to the regulatory jurisdiction of state banking regulators, but federal law now controls all of these issues."[55]

THE SECURITIES AND EXCHANGE COMMISSION (SEC)[56]: PRIMARY REGULATOR OF US SECURITIES MARKETS

As part of the New Deal legislation, the SEC was established under the Securities Exchange Act of 1934. The main objectives of the SEC are to ensure the integrity of the securities market and to protect investors in line with the provisions of the federal securities acts in force. Its tasks include the disclosure of financial information of publicly traded companies and oversight over broker-dealer firms, investment advisors, mutual funds and self-regulatory organisations (SROs), which include, inter alia, the stock exchanges and the National Association of Securities Dealers (NASD). In this context, the SEC reviews and approves proposals for new rules and for changes to existing rules filed by the SROs. It has enforcement authority against individuals and companies who infringe the securities laws (insider trading, accounting fraud or providing false or misleading information).

The SEC is the primary regulator of the US securities markets[57] with the individual states playing only a secondary role. While so-called Blue Sky laws[58] are still in force in individual states, states have refrained from developing their securities law as the federal level has increasingly regulated this area and effectively "occupied the field" of securities regulation.[59] That said, it is worth mentioning the recent action under New York State laws by NY Attorney General Elliot Spitzer to fight conflicts of interest arising out of investment research undertaken by analysts at Wall Street investment banks (see footnote 104).

The dominant role of the federal level and the SEC in securities regulation, which features, among other things, an extensive system for SEC registration, disclosure and liability (backed up by the mechanism of class action lawsuits) has attracted both admiration and criticism. Proponents of a strong role for the SEC refer to the importance of liquidity, product diversification and innovative capacity of the US market to which the SEC has contributed. Others point to the monopolisation of securities regulation and oversight and the resulting undesirable consequences, such as undue bureaucracy (leading to unnecessary disclosure requirements) and excessive transaction costs due to a favouring of investment banks and traders over issuers.[60/61] Critical remarks are mostly made by academics, but less so by politicians or the financial industry.

With the passage of the Sarbanes-Oxley-Act (SOA) the SEC was further strengthened. Parts of corporate law that, until that time, had been considered to be the exclusive regulatory

55 See Macey (2001), p. 102. While the formal decision on the closure of a state bank continues to be taken by state authorities, the FDIC has the authority to revoke the bank's deposit insurance, essentially forcing it to be closed down.

56 The SEC consists of five Commissioners, with one serving as the Chairman, and all of whom being appointed by the President with the advice and consent of the Senate for staggered five year terms. The SEC has approximately 3,100 staff and has its headquarters in Washington D.C. It has 11 regional and district offices throughout the country.

57 The supervision of financial derivatives and commodities markets falls under the competence of the Commodity Futures Trading Commission (CFTC).

58 The term "Blue Sky laws" has its origins in the unrealistic promises that sellers of securities made to investors.

59 See Jackson (2001), p. 7. State securities regulators are in fact more like service organisations helping to protect the interests of investors resident in their state. They are often first to identify new investment scams and to bring enforcement actions to remedy a wide variety of investment-related problems. They co-operate within the North American Securities Administrators Association (NASAA), founded in 1919, whose membership extends beyond the USA and consists of 66 state, provincial and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, Canada, and Mexico.

60 As Macey (2001), p. 108 puts it: "In fact, there is some evidence that the SEC has been captured by the trading community, and is therefore unlikely to produce the exchange rules that are best for investors."

61 The critique notably is inspired by the example of successful regulatory competition for corporate charters in the US. See especially Romano (2002), but dissenting opinion comes from Bebchuk/Ferrel (2001), p. 90 f., who claim that the lack of a federal take-over law has led to state takeover legislation favouring management over shareholders.

domain of the states, were then federalised. Reacting to corporate scandals (e.g. Enron, WorldCom), for the first time Congress regulated such issues as the composition, role and function of the board of directors of public corporations. Among other things, the SOA partially pre-empts state law governing the appointment, removal, and compensation of directors and officers. The SEC is now empowered to remove officers and directors from their positions on mere grounds of "unfitness". Moreover, the New York Stock Exchange (NYSE), under the aegis of the SEC, promulgates corporate governance listing standards (e.g. on director independence) which effectively supersede state corporate law.[62]

One reason why the centralisation in US securities and increasingly also in corporate governance regulation has been accepted, is that the SEC is regarded as an effective regulator which spoke out in favour of strengthened corporate governance rules long before the passage of the SOA. Moreover, given the risk of confusion and regulatory overlap in regulatory competition, uniform requirements coming from a single regulator appear more attractive.

4 RULE-MAKING BY REGULATORY AGENCIES: A CASE STUDY OF THE OCC

Federal regulatory agencies enjoy considerable powers. The OCC's power can be exemplified by its 2004 rule-making on "anti-predatory lending laws", i.e. laws protecting weak customers from abusive bank practices in the sub-prime mortgage lending market. The OCC declared relevant state laws not applicable to national banks and prescribed anti-predatory lending standards for national banks' lending activities. This move was met with considerable opposition from state representatives (governors, supervisors and attorneys general).

The speed and authority with which the OCC has proceeded is remarkable. It started the procedure on 5 August 2003 with the publication of a notice of proposed rule-making (NPRM), received 2,600 comments from interested parties by the end of the consultation period (6 October 2003) and took a decision on 6 January 2004. The decision was published in the Federal Register[63] on 13 January 2004 and took effect on 12 February 2004, just over 6 months after the issuing of the NPRM.

In its final rule, the OCC, in essence, declares the applicability of state consumer protection law relating to real estate lending as pre-empted and justifies its action by referring to the US Constitution, the National Bank Act and the Supreme Court. In tandem with these pre-emption provisions the OCC adopted supplemental and by nature – uniform – anti-predatory lending standards governing national banks' lending activities.

During the two-month consultation, the comments supporting the OCC's proposed rule came from national banks and banking industry trade groups. They pointed out that, in effect, a national bank must often craft different products or services for each state in which it does business, or accept not to provide all of its products or services in one or more states. The OCC rule would offer much-needed clarification of when state law does or does not apply. Without such clarity, the burden and costs associated with the numerous state and local laws might be a significant deterrent to national banks' willingness and ability to offer certain products and services in certain markets.

Among those who were against the OCC's proposed rule, real estate companies feared that their own affiliated lending operations would become disadvantaged because they would continue to be subject to state law while national banks and their operating subsidiaries would no longer be bound by those same laws

62 See Bainbridge (2003), p. 29 f.
63 Federal Register/Vol. 69, No. 8/Tuesday, January 13 2004/ Rules and Regulations.

and rules. State officials[64] and members of Congress questioned the legal basis of the proposal and argued that the OCC lacked the authority to adopt it. These commentators, exemplified by the attorneys general[65], specifically pointed out that "the OCC's efforts to deal with the very substantial problem of predatory lending … fall short of the actions taken by many states." The attorneys general also objected to the OCC proposal to extend pre-emption rules to operating subsidiaries of national banks. This would amount to "federalizing state-chartered subsidiaries ... effectively destroying the dual banking system that is valued by both Congress and the States." "The States would be deprived of all authority to regulate these state-chartered corporations, which include mortgage companies that have long been licensed by States."

More generally, attorneys general criticised the OCC's analysis of pre-emption as "one-sided and self-serving". They criticised its "aggressive advocacy role in favour of pre-emption in the federal courts". It is interesting to note that the attorneys general acknowledge that the OCC succeeds in persuading most of the federal courts "to ratify its aggressively expansive pre-emption policy".

The concerns voiced by commentators were, for the most part, not taken up in the final rule. In the "Regulatory Analysis" part of its published rule, the OCC pointed out that it had fulfilled legal requirements (e.g. consultation meetings with representatives from CSBS[66]) and described the extent to which the concerns expressed (extent of pre-emption, undermining of the dual banking system, adequacy of consumer protection) had been addressed. The OCC basically reiterated that its position conformed with federal law and judicial precedent, that the final rule preserved the dual banking system and, finally, that the OCC had ample legal authority and resources to ensure that consumers were adequately protected.

This case study illustrates that federal agencies – sometimes with the support of federal courts – push for harmonisation and uniformity quickly and decisively.[67] If Congress considers that the OCC – or any other regulatory agency – has exceeded its powers, it has, by virtue of the Congressional Review Act of 1996, the power to review and possibly reject major agency rules within a period of 60 days.[68] Only if a motion of disapproval passes both the House and the Senate, and is then signed by the President, does the respective rule not come into force and the agency is banned from publishing a similar version of the rule at a later date. So far, however, the Congressional Review Act has never been successfully invoked. Furthermore, if there were to be a fundamental disagreement between Congress and the OCC about the latter's regulatory

64 State banking regulators, the Conference of State Bank Supervisors (CSBS), the National Conference of State Legislators, individual state legislators, the National Association of Attorneys General and individual state attorney generals (AGs).

65 Letter of the National Association of Attorneys General, signed by all 50 AGs, to the OCC from October 6 2003. The very active and visible role played by the state Attorneys General can be explained by the non-involvement of states in federal rule-making. Attorneys General, as elected officials, forcefully defend the prerogatives of their respective state.

66 The so-called Federalism-order (Executive Order 13132) requires federal agencies, including the OCC, to certify their compliance with that Order whenever a proposed rule has "substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government." In the case of a regulation that has Federalism implications and that pre-empts state law, the Order imposes certain consultation requirements with state and local officials, requires publication in the preamble of a Federalism summary impact statement, and requires the OCC to make available to the Director of the Office of Management and Budget (OMB) any written communications submitted by state and local officials. These requirements must be satisfied before the OCC promulgates a final regulation.

67 Interestingly, Congress had earlier expressed its view that state law would continue to apply to the interstate operations of national banks, particularly in the area of consumer protection. (See report of the House-Senate conference committee on the Riegle-Neal Act, quoted in the Letter by AGs of October 6 2004, p. 5.) Nevertheless, as already stated above, the OCC had been given authorisation by federal law, the National Bank Act, to pre-empt state laws, an authority which was subsequently confirmed by decisions of the Supreme Court. See report of the House-Senate conference committee on the Riegle-Neal Act, quoted in the Letter by AGs of October 6 2004, p. 5.

68 "Major" is defined as a rule that is estimated to have an annual effect on costs for the economy of more than USD 100 million.

powers, Congress could simply change the National Bank Act if deemed appropriate, or leave the matter to the Supreme Court.

5 SPEED AND FLEXIBILITY IN RULE AND LAW-MAKING

In order to make financial regulation more responsive to changes in financial markets, the EU has created the so-called Lamfalussy framework. It differentiates between framework legislation, established under the co-decision procedure (i.e. involving both the Council and the EP), and more detailed technical rules, passed via the speedier "comitology" procedure. While this approach has the potential to increase the adaptability of financial market regulation, it does not provide for the flexibility and scope of action of US-style regulatory agencies.

In the US, important pieces of financial regulation such as the Basel II rules will be adopted by the regulatory agencies alone. By contrast, in the EU, the main body of the new Capital Directive as well as most of the technical details contained in the annexes will be passed under the co-decision procedure. Only subsequent changes to the annexes will be dealt with under the potentially faster comitology procedure. Moreover, while the EU Capital Directive will require transposition into national law by Member States, US rules will apply directly. Finally, translation into the different languages of the European Union can cause a bottleneck in the rule-making process. This inevitably puts the EU at a disadvantage in terms of speed. In particular, a prolonged legislative process may arise when the EP acts as co-legislator. In this case, Members of the European Parliament may be lobbied to file numerous amendments. By contrast, US regulatory agencies, while being subject to oversight by Congress, do not need a formal stamp of approval by Congress for the rules they issue. Lobbying by interest groups is thus "filtered", taking place in a more indirect way by convincing members of Congress to support their cause in the context of the congressional oversight function (e.g. in congressional hearings with agency officials).

While the US-style agency structure undeniably has its advantages, the effectiveness of regulatory action in the US may, at the same time, be hampered by the fact that there are several federal regulators. When uniformity is required and Congress has not given a specific agency the lead authority to deal with a certain issue,[69] it may arise that the regulators cannot reach an agreement with each other. This risks slowing down the rule-making process or even leading to regulatory gridlock.[70] During the congressional hearing on the proposed – but finally rejected – Regulatory Consolidation Act 1994[71], the then Comptroller of the Currency, E. Ludwig, referred "… to the long histories of independent action that have hardened [the agencies'] resistance to accommodate opposing points of view (…) In those circumstances, debate among the agencies can take on the aura of deliberations among sovereign powers that have great difficulty reaching consensus on almost any issue within meaningful time frames."[72] The risk of regulatory stalemate is particularly present if Congress is not plain about its objectives. If Congress, however, has a clear view on what it wants to achieve, it can threaten to legislate directly and thus speed up action by regulatory authorities.

In the EU, the speed with which financial legislation can be adapted to developments in the financial markets depends on the extent of delegation of technical adaptations to the level II Lamfalussy committees by the EU legislators and on the efficiency of the committees. The preparedness of the political level (Council,

69 The Federal Reserve, for example, has exclusive authority to write the "Truth-in-Lending" regulations.

70 Furthermore, the risk was pointed out that the US position in international financial negotiations might be weakened by the fragmented nature of the US system. See GAO (2004), p. 18. According to some observers, co-operation among agencies with regard to Basel II was not without friction.

71 See Chapter 8 below.

72 See Ludwig (1994), p. 149.

EP) to delegate crucially depends, in turn, on the satisfaction with the way in which the Commission exercises its regulatory role. If market participants get the feeling that their views are not adequately taken into account, they may lobby governments and members of parliament to keep as tight a grip on legislation as possible with the consequence that technical details are regulated on level I, which ideally should be restricted to the broad framework.

Changes to the broad framework of financial market legislation – as opposed to detailed rule-making – may require a lot of time on both sides of the Atlantic. This is particularly true for institutional reform, which is much more difficult in a multi-layered governance structure, with many interest groups playing their role (as in the US or the EU), than in a system of centralised decision making like that of the UK.[73] In the US, attempts to reform the US banking supervisory structure by creating a single federal banking agency have been going on at intervals over the last forty years. Most recently, law makers again failed in 1994, not least because banking profitability was high and the public at large lacked interest in the subject (see Chapter 8 below). Institutional reform is particularly cumbersome in the EU if a change to the Treaty becomes necessary. Any change to the Treaty requires unanimity of all EU governments in an intergovernmental conference and subsequent ratification, which is difficult to achieve in a union of 25 or even more Member States. The risk of an ossification of institutional structures at EU level thus seems to be even higher than in the US, where federal regulatory agencies have been established and can be changed by acts of Congress with simple majority, hence not requiring a change in the US Constitution.

Generally, the seriousness of the problems concerned plays a decisive role in the speed of action: for Sarbanes-Oxley and the creation of the Public Companies Auditing Oversight Board (PCAOB), it took less than eight months after the corporate scandals had surfaced[74] for Congress to pass the law. By contrast, the passing of the Gramm-Leach-Bliley Act took two decades, because pressure was subdued and institutional conflict prevalent[75]. In the EU, a clear program and the deadlines set by the Financial Services Action Plan led to a rapid adoption of important pieces of legislation, including the legal framework underpinning the Lamfalussy process, and accelerated the adoption of legislative measures, such as the European Company Statute, which has been discussed for more than 30 years.

6 DRIVING FORCES AND ACTORS IN FINANCIAL REGULATION

It has already been pointed out that, in the US, crisis has been an important driving force for the creation of new institutions (e.g. OCC/Civil War, Federal Reserve/widespread banking crisis, FDIC and SEC/Great Depression, PCAOB/corporate scandals) or the reform of existing ones (e.g. FDIC/banking and S&L-crises)[76] ("positive" integration). Crisis,

73 "The blockade of institutional reform in the US ... can best be explained ... by the tendency of Congress for stalemate in dealing with contested measures in the maze of committees and sub-committees." This can be contrasted to the creation of the FSA in the British Westminster system with its "unchecked centralisation of power", see Busch (2002), p. 13.

74 Enron collapsed in November 2001, Sarbanes-Oxley entered into force on July 30 2002. Criticism was, however, raised with regard to the quality of the substance of the Act.

75 "Congress has been working for 20 years to remove the Depression-era barriers that separate banking, insurance and securities," Sen. Phil Gramm said during the Senate proceedings in July 1999, "… and for the first time in 20 years, both houses of Congress have passed bills to do that." The fact that many interest groups were influencing the outcome meant that a short and simple bill calling for the repeal of the Glass-Steagall and the Bank Holding Company Acts in 1999 did not come about. Kaufmann (2000), pp. 42 f. describes the legislative process as follows: " ... the driving forces have been primarily vested interests, fighting each other for gains in a mostly zero-sum game. The process has been a lobbyist's delight … Foremost of these is Citigroup, which needs congressional approval to maintain and fully integrate all the activities acquired in Citicorp's earlier merger of equals with Travellers Insurance. If not legislatively permitted within five years, some of these activities, particularly insurance underwriting, could not be conducted by Citigroup or any of its affiliates."

76 The reform of the FDIC was accompanied by the conversion of the Federal Savings and Loan Insurance Corporation (FSLIC) into the Savings Association Insurance Fund (SAIF), which was placed under the control of the FDIC.

however, has not been the only force shaping the financial framework. Competition is the other force at work, including competition among regulators that is induced by technology, globalisation and structural change. This has led to greater liberalisation of markets ("negative" integration).

In the US, there is a clear link between the two driving forces of competition and crisis and the activities of policy-makers, i.e. state authorities, federal regulatory agencies or Congress. When adapting to or creating a more competitive environment was the issue, the states (e.g. when lifting branching restrictions) or the federal regulatory agencies (e.g. the Federal Reserve Board when gradually dismantling Glass-Steagall) took the lead. When reacting to deep crises – very often in a restrictive way – it was Congress which took the initiative, mostly because the public expected its representatives in Congress to do so.

In cases of "negative" integration, i.e. liberalisation, Congress has to a considerable extent only ratified ex post what had already been granted by the states or regulatory agencies. One explanation why states and regulatory agencies were more proactive in deregulating than Congress might lie in their desire to increase their regulatory constituency. The Fed is one, but not the only, example of an agency fuelling regulatory competition. In the context of the GLBA, the Fed was identified as a big driver in connection "with its ongoing turf battle with the comptroller of the currency for regulatory supremacy in banking."[77] For its part, the OCC used inter alia its pre-emptive power to expand what national banks are empowered to do. Although regulatory competition as a driving force played much less of a role for Congress in the past[78], global integration of markets and competition with the EU could, however, make Congress more responsive to new challenges (as was already the case with the Sarbanes-Oxley-Act).

In the EU, both the driving forces as well as the actors in financial legislation/regulation are different from those in the US. More than regulatory competition among agencies or among states or the need to react to crises, the compelling force for financial market regulation in the EU has been the desire to foster integration so as to create a more competitive European financial market place.[79]

With regard to the actors, the strong role of the Member States in the European construction stands out again. Although the European Commission formally has the exclusive right of initiative for financial regulation, it must take into account the positions of Member States as much as possible. In its initiatives in the financial services field, the Commission is informed by the views expressed in the Financial Services Committee (FSC), which, as a Council body, comprises high-level representatives of the finance ministries of Member States shaping opinions on strategic questions of financial markets legislation.[80] At a more technical level, the Commission receives advice from the competent Lamfalussy committees comprising again officials and experts from Member States. Given the importance of Member States in the decision-making process, lobbying efforts regarding EU rules are not only directed at the EP but also at Member States governments. By contrast, in the US, lobbying by the well

77 See Kaufman (2000), p. 42f. More recently, in connection with "Basel II" it was again primarily the Federal Reserve Board who reacted to big banks' concerns of increased competitiveness on the international level.

78 "Critics had argued that the two congressional banking committees preferred not to pass legislation, since the perenniel prospect of a bill works wonders in fund raising." See Calomiris (2000), p. xxv. To be fair, difficulties of Congress in passing financial regulation may result also from the fact that other committees besides the banking committees have a say in bills that encompass the securities markets or insurance.

79 To achieve this, the concepts of minimum harmonisation and mutual recognition were developed. However, due to the absence of a "true mutual recognition culture" (see Lannoo/Casey (2005), p. 25) the single financial market is still not a reality in all financial market segments.

80 The Commission also nominates a member to the FSC. The ECB and the Chairs of the relevant Community committees of regulators have observer status.

organised financial services interest groups[81] is concentrated on the federal level, i.e. on Congress [82/83], both to influence law-making by Congress and the way in which congressional committees exercise oversight over the regulatory agencies.

7 THE INTERPLAY BETWEEN REGULATORY AGENCIES: CO-OPERATION AND REGULATORY COMPETITION

Although US financial activity was liberalised to a large extent both in geographical as well as in functional terms during the 1990s, the institutional set-up for regulation and supervision remained largely unchanged. However, as the multitude of regulators/ supervisors on the state and the federal level places a premium on effective co-operation among agencies[84], various forms of co-operation have developed over time.[85]

In banking supervision, co-operation has been institutionalised at the federal level in the *Federal Financial Institutions Examinations Council* (FFIEC) and, long before at the state level, in the *Conference of State Bank Supervisors* (CSBS). The FFIEC was established in 1979 as a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Federal Reserve Board, the FDIC, the National Credit Union Administration (NCUA)[86], the OCC and the Office of Thrift Supervision (OTS) and to make recommendations to promote uniformity in the supervision of financial institutions. It provides, inter alia, schools for examiners and training seminars on risk management. While the agencies represented in the FFIEC share information and coordinate among themselves, they maintain their independence. As a result, while the FFIEC has achieved more consistency in dealing with supervisory issues and reporting forms, its recommendations have not always been adopted uniformly.[87] Furthermore, there is ad-hoc co-operation among federal agencies dealing with specific questions such as money laundering and terrorist financing.

At the state level, the *Conference of State Bank Supervisors (CSBS),* which was founded in 1902, serves as a coordinating body for

81 Among bank trade associations, the American Bankers Association (ABA) is the oldest and largest. It views itself as the voice of the entire commercial banking industry. The Independent Community Bankers of America view themselves as the true voice of small banks, and competes with the ABA for those banks' support. State banking associations also play an important role in conveying the views of bankers in each state (both state and national banks) to the state and federal regulators/legislators. The Financial Services Round Table encompasses top executives of large, expansion-minded banks and non-bank financial institutions. See Macey/Miller/Carnell (2001), p. 77f.

82 Kroszner/Stratman (1998), p. 1164 cite a study according to which financial services' political action committees constitute the single largest group of contributors to legislators, providing nearly 20 percent of total contributions (see Makinson, L., "Open secrets: The encyclopedia of congressional money and politics", Washington D.C., Congressional Quarterly, Inc. 1992.) The influence of academic experts and think tanks catering to a particular political perspective is also a feature, which seems to be more developed in the policymaking environment of Washington than of Brussels. Clearly, the academic community made an important intellectual contribution to the introduction of prompt corrective action in the FDICIA and to the dismantling of Glass-Steagall in the GLBA. See Axarlis (2004), p. 15 and 18.

83 Lobbying in Brussels is targeted at the Commission that drafts the initial proposals and, at a later stage, at the EP acting as co-legislator with the Council.

84 Spong (2000), p. 50 succinctly describes the layers of banking regulation/supervision in the US: "The presence of both federal and state authorities has brought almost all banks under the regulatory authority of more than one agency. All banks fall under the supervision and regulation of their chartering authority, at either the state or federal level. If deposit insurance is obtained – as it virtually always is – a bank is subject to certain statutes of the Federal Deposit Insurance Act and, in the case of state non-member banks, to direct FDIC supervision. If a state bank becomes a member of the Federal Reserve System, the Federal Reserve is its primary federal supervisor. Also formation of a bank holding company or a financial holding company subjects banks and banking organisations to an additional layer of regulation and supervision at the parent company level. Moreover, banking organisations may further be subject to the oversight of insurance, securities or other regulators as they take on non-banking activities."

85 The need for effective co-operation and communication was stressed recently by the US Government Accountability Office especially with regard to systematic information sharing across sectors. See GAO (2004), p. 104 and p. 109.

86 The NCUA is the independent federal agency that since 1970 charters and supervises federal credit unions. It is the successor of the Bureau of Federal Credit Unions that was established in 1934.

87 See Spong (2000), p. 58.

achieving supervisory convergence, but also as a lobbying institute for state banking in Washington. It regularly delivers comment letters to the OCC in the context of notices of proposed rule-making. Moreover, it provides a forum for discussing issues of common interest to all state regulators and assists states in maintaining efficient agencies. Its membership includes state supervisors as well as many state banks.[88]

The CSBS played a decisive role in providing a basis for co-operative efforts among the state supervisors and as the natural interlocutor for discussion on supervisory agreements with federal agencies in the context of the liberalisation of interstate branching in the mid-nineties. In 1996, two key agreements were concluded with the active involvement of the CSBS: the *Nationwide Co-operative Agreement* among state supervisory authorities on 13 November 1996, and the *State/Federal Supervisory Agreement* between state supervisory authorities, the Federal Reserve Board and the FDIC on 14 November 1996.[89/90] Both agreements – as well as later agreements concerning large complex banking organisations and foreign banking organisations (FBOs) – are inspired by the goal of providing seamless, flexible and risk-focused supervision, minimising regulatory burden and fostering consistency and coordination among the appropriate regulators.

The agreements are the outcome of efforts by the state banking system to remain attractive to its "regulatory constituency". If, due to a lack of coordination between state banks and their

88 The CSBS, addressing potential members via its homepage, describes itself as "a member-driven organization that brings regulators and bankers together for a common purpose. Your bank's support helps us deliver on our core strategic functions: to educate, coordinate, advocate and communicate for the advancement of the state banking system."

89 The State Federal Working Group (SFWG) worked out concrete proposals for the State/Federal Agreement of 1996. Given the need to co-operate more closely between the federal and state level under conditions of liberalised bank branching, the Group was established in October 1995 as an ad hoc committee composed of state bank regulators and top regulatory officials of the FDIC and the Federal Reserve.

90 The *Nationwide Coooperative Agreement* sets out the responsibilities of the home state supervisor and the host state supervisors for multi-state banks. In concrete terms, the home state supervisor is defined as the primary regulator responsible for the supervision of its state-chartered banks and its out-of-state branches. His tasks include the examination of safety and soundness and compliance with applicable laws and responsibility for coordination with the host state supervisors and the appropriate federal bank regulatory agency. The home state supervisor *may* request the host state supervisor's participation to examine safety and soundness, trust and electronic data processing. He *should* use host state examiners to examine the compliance with host state laws regarding community reinvestment, consumer protection and fair lending and rely on their guidance in this respect. (The parties to the nation-wide agreement "recognize, that host state supervisors have a legitimate interest in monitoring the safety and soundness of out-of-state banks that operate branches in their states and in making sure those branches are operated in compliance with host state law.") The home state supervisor shall designate the examiner-in-charge, who may also be an examiner employed and selected by a federal bank regulatory agency. The examiner in charge shall designate the examination responsibilities of each examiner involved in the examination. Unless otherwise expressly provided under host state law, the home state supervisor shall have approval authority over all applications from a multi-state bank.
The *State/Federal Supervisory Agreement* outlines the responsibilities of the responsible federal agency and the home state supervisor. Both designate a primary contact person for each multi-state bank. The contact persons will coordinate the supervisory and examination responsibilities of their respective agencies. In principle, safety and soundness examinations will be conducted on a joint basis, with a joint examination team issuing a single examination report. (The agreement explains in footnotes that the joint examinations are not intended to supersede existing Alternate Examination Programs ("AEP"), which are conducted by either the responsible federal agency or the home supervisor, which will also issue the examination report. It furthermore clarifies that joint examinations will normally be used for the larger, more complex organisations, while alternate examinations are generally reserved for small organisations.) In exceptional circumstances, e.g. when there is significant safety and soundness risk, the responsible federal agency or the home state supervisor may conduct independent or special examinations (giving prior notice to the other regulator). In developing a comprehensive supervisory plan, the primary contact persons will consider the view of the local Federal Reserve banks, the local FDIC regional offices and the host state supervisors, as appropriate. The responsible federal agency and the home state supervisor *may* agree to have one examiner-in-charge (EIC) or may each assign a co-EIC (which may coincide with the primary contact persons) to manage the on-site, joint examination. Consistent with the goal of "seamless supervision", the agreement requires that all aspects of the examination process are fully coordinated and that duplication is avoided. The parties to the agreement also resolve to coordinate fully the applications process by promoting consistency in approach (e.g. developing common forms and introducing concurrent processing periods). What is clearly expressed is that the provisions of the agreement do not supersede statutory or regulatory obligations of a bank to provide specific information or to file required reports with a federal or state supervisor.

federal supervisors (Fed, FDIC), supervision becomes too burdensome for multi-state state banks, they can opt to become a national bank. This would neither be neither in the interest of the state supervisor, nor of the Fed or the FDIC.[91]

In an effort to facilitate cross-border banking activities, state banking authorities use CSBS as a means to achieve supervisory convergence. In its public compendium, "Profile of State Banking", CSBS staff have been creating transparency by surveying state laws in relation to topics, such as branching, non-bank-activities and so on. The "Profile" is intended to encourage greater substantive uniformity and to be a source for identifying particular state laws that may raise issues for multi-state providers.[92] Furthermore, CSBS provides added value to its supervisory members, by accrediting individual state supervisors for meeting CSBS standards for bank examinations, which is used as a "marketing argument" by state agencies.[93]

While banking regulation in the 1930s led to stronger federalisation with the creation of the FDIC and a strengthening of the Fed[94], state banking authorities nowadays regard the FDIC and especially the Fed as valuable allies in their endeavour to create attractive conditions for state banks and thus to keep national banking in check. The Federal Reserve Banks, for their part, contribute to this effort by offering state-chartered banks membership in the Federal Reserve System and thus high quality and efficient supervision. The Federal Reserve Bank of Boston, for example, points out that "the Federal Reserve's local supervision model is closely aligned with the state banking model, and is supportive of the dual banking system." Furthermore, the efficiency argument is put forward as follows: "In the case of a state member bank owned by a bank holding company, the Federal Reserve directly supervises both institutions, promoting a consistent supervisory approach for the entire organization."[95]

While the dual banking system has been criticised for creating a "redundant and conflicting"[96] regulatory structure and "being duplicative and never easy to explain"[97], it may be credited for exerting a favourable influence on regulatory/supervisory competition in the US.[98] On the side of – both state and federal – supervisors and policy-makers there is continuing support for the dual banking system. The state bank supervisors claim that a separate system of state banks "allows the states to serve as laboratories for innovation and change, not only in banking powers and structures, but also in the area of consumer protection".[99] According to the Comptroller of the Currency "the national banking system is the venue for testing and evaluating the efficiencies and benefits that flow from uniform national standards […]. In other words, the national banking system is a laboratory too, but what it demonstrates is the value of

91 In the case of national banks, the Fed and the FDIC only receive the examination reports from the OCC.
92 See Eager R. C. and Muckenfuss C. F. (2003), p. 30.
93 Accreditation is done on a voluntary basis. The accreditation program started in 1984 with the state banking department of Illinois. Currently, 45 departments out of 54 CSBS members (i.e. the fifty states plus Washington D.C. and the "unincorporated organized territories" of Guam, Puerto Rico and the Virgin Islands) are accredited. The confidential accreditation procedure is based on an independent assessment of the fulfilment of CSBS examination standards by a panel of retired state and federal regulators. A review of the accreditation is undertaken every five years.
94 With the creation of the FDIC, state banking agencies lost their position as sole regulators of state non-member banks. Moreover, in the Banking Act of 1935, there was even a requirement for insured state non-member banks to join the Federal Reserve System, a requirement that was removed under the pressure from state agencies and non-member banks in 1939. See Spong (2000), p. 24.
95 The Reserve Bank further stresses that it demands no examination fees. See Federal Reserve Bank of Boston, "Federal Reserve Membership for a State-chartered Bank", on the Internet.
96 Hammond, B. (1970), "Sovereignty and an Empty Purse: Banks and Politics in the Civil War", p. 349-50 cited in Broome (2002), p. 220.
97 White (1999), p. 2.
98 Empirical research points, in particular, to regulatory specialisation, " … allowing banks to move to a better risk-return trade-off by switching regulators when they are switching business strategy", see Rosen (2001), p. 19.
99 Testimony of J. A. Smith, Jr., North Carolina Commissioner of Banks, on behalf of the Conference of State Bank Supervisors, before the House Committee on Financial Services, June 4 2003.

applying uniform national standards to activities and products that, today, have national markets."[100]

The Chairman of the Board of Governors of the Federal Reserve System, A. Greenspan, argued that "when there is no choice of regulatory agency, rigid policies and interfering regulatory micro-management can develop."[101] "A single regulator, charged with responsibility for safety and soundness, is likely to have a tendency to suppress risk taking. A system of multiple supervisors and regulators creates checks on this propensity."[102] It has also been pointed out that regulatory competition and even "messiness" is not always bad, and could lead to unexpected dynamism.[103/104]

As regulatory agencies are keen to avoid any discrimination against the intermediaries under their jurisdiction, they try to bring Congress on their side when federal legislation puts their interests at risk. A good example is the amendment which – under the influence of the state regulators – was passed in 1997 to the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. The amended statute states that interstate branches of a state bank are subject to the laws of the host state only to the extent that an interstate branch of a national bank in that host state is subject to host state law. Otherwise, home state law applies. In this specific context, it was the Conference of State Bank Supervisors (CSBS) which provided leadership in an effort to provide state banks with legal parity in a federal law (thereby creating "competitive equality"). Before the amendment, Riegle-Neal provided that all host state law would apply to state bank branches, while only part would apply to national banks. Interestingly, up to 1994, state banking officials called for the possibility to apply different rules to national and state banks in order to allow them to apply host rules to banks incorporated under another state's charter. [105] Only when they became aware that this would mean a competitive disadvantage for their "clients" – possibly driving them away from their state charter to the national charter – did they change their position.

While there is considerable competition between agencies in attracting banks to register under their jurisdiction[106], this competition is kept in check by the federal power to regulate. This means that states are unlikely to exaggerate in granting state banks an overly favourable regulatory framework or to impose restrictive state legislation on national banks since the federal legislator/regulator could simply legislate/regulate against such action. In other words, regulatory competition in the US is constrained by the supremacy of federal law, which ultimately determines the leeway of financial institutions in exercising their activities. Given the existence of federal deposit insurance and interstate banking and branching, the federal level has a natural interest in assuming responsibility for the safety and soundness of depository institutions.[107] If it were not to assume this responsibility, a sub-optimal situation could arise, whereby state regulators

100 See Comptroller of the Currency (2003), p. 10.
101 See BNA Banking Report, March 7 1994.
102 See Greenspan, "No Single Regulator for Banks", Wall Street Journal, December 15 1993.
103 See Walter I. (2003), p. 42.
104 Regulatory competition in the US is fostered also in terms of enforcement, as can be seen by the role of New York's attorney general, Eliot Spitzer, in the context of the 2001/2002 proceedings against major investment banks in New York over the integrity of their investment advice. In his view, the SEC had initially failed to act, justifying his stepping into the breach. While Spitzer's action was criticised by the Shadow Financial Regulatory Committee (SFRC), which wants the securities markets in its essential aspects to be regulated exclusively by federal authority, it has been contributing to more vigilance on the side of the SEC. See SFRC, "State and Federal Securities Market Regulation", Statement Nr. 186, www.aei.org/publications.
105 See Eager/Muckenfuss (2003), pp. 4 and 16.
106 "... As US bank regulatory agencies vie for control, they have tried to bolster their relative position by offering new powers to banks that choose them as the banks' primary regulator (through the bank's choice of charter and holding company structure)", see Calomiris (2000), p. xvi.
107 With the FDICIA of 1991 and its system of capital-based prompt corrective action, a core component of safety and soundness regulations has been established, whereby the federal banking agencies must establish minimum capital levels. They are the yardstick for judging if an institution is well-capitalised, adequately capitalised, undercapitalised, significantly undercapitalised or critically undercapitalised. Based on this, the federal regulator can take corrective action (e.g. requiring recapitalisation). See Macey/Miller/Carnell (2001), pp. 309ff. Furthermore, under the FDICIA, the FDIC has the authority to prevent state banks from taking on any broader powers that would put the deposit insurance fund at risk. See Spong (2000), p. 40.

succumb to the incentive to offer regulatory relief to state-chartered institutions in an increasingly competitive environment.

What nowadays stands out in the US is not only "controlled" regulatory competition between state and federal levels but also competition between supervisory agencies offering high-quality supervision at a reasonable cost. In this respect, state agencies together with the FDIC or the Fed on the one hand and the OCC on the other hand have an incentive to be efficient, given the freedom for banks to switch charter at low cost. In this context, the state agencies, the FDIC and the Fed need to compensate for the advantage the OCC has in being able to use its pre-emptive powers to simplify operations of nation-wide active banks. With regard to the supervision of state banks, the Fed and the FDIC compete for being their primary federal regulator. While, in this context, banks have access to central bank liquidity irrespective of their federal regulator, being a member of one of the Federal Reserve Banks is still considered as a "reputational" asset.

8 STREAMLINING OF SUPERVISION IN THE US: A DIFFICULT EXERCISE

Given its complex structure, the US regulatory/supervisory system has been criticised for creating regulatory overlaps and gaps and for weakening accountability. Moreover, in the case of the Fed, it has been argued that a conflict of interest could emerge because of its dual responsibility for monetary policy and financial supervision. More recently, in a report to Congress, the US Government Accountability Office (GAO) noted that although the regulatory system had been generally successful, it lacked overall direction and – despite the GLBA – did not facilitate the oversight of large, complex firms.[108]

To date, efforts to streamline the system have concentrated on the federal level and the four federal banking agencies (OCC, OTS, Fed, FDIC).[109] However, numerous efforts to consolidate the banking supervisory structure[110], even those with significant political backing, have so far failed.

In 1984 the Task Group on the Regulation of Financial Services, chaired by the then Vice President Bush, recommended to Congress that a Federal Banking Agency be created into which the OCC would be absorbed, while the regulatory role of the Fed and the FDIC would be substantially reduced. The Fed would have continued to play a role only with respect to the largest bank holding companies and the FDIC would have concentrated on its role as insurer. The Task Group's recommendations were not received well by Congress which criticised, inter alia, the " … politically motivated attempts to decrease the [Fed's] regulatory independence … "[111]

In 1994 the Clinton administration made a similar proposal to that of the Task Group, which also failed to win congressional approval. While it was universally acknowledged that the system needed reform, views differed on whether a single Federal Banking Commission, as suggested by the Administration (and supported by OCC and OTS),[112] would need to be

108 The GAO inter alia put forward the idea of having a single regulatory entity for all systemically relevant financial services firms. This entity could be an existing regulator or a new one. The GAO acknowledged, however, that it could be difficult to maintain an appropriate balance between the interests of the large firms and of the smaller, more specialised firms. See GAO (2004), p. 23.

109 The possible integration of the federal securities supervisors (SEC/CFTC) and federal banking agencies into one single entity was never seriously considered by Congress.

110 A recent study by the FDIC describes 24 major proposals that have been put forward as from the 1930s. See Kushmeider (2004), pp. 65–74.

111 See Malloy (2002), p. 182f.

112 Interestingly, in 1991 the Department of the Treasury argued that a multiplicity of regulators brings a broader perspective to financial services regulation: "The existence of fewer agencies would concentrate regulatory power in the remaining ones, raising the danger of arbitrary or inflexible behaviour … Agency pluralism, on the other hand, may be useful, since it can bring to bear on general bank supervision the different perspectives and experiences of each regulator, and it subjects each one, where consultation and coordination are required to the checks and balances of the others opinion". See US Department of the Treasury, Modernizing the Financial System, February 1991, page XIX-6.

created. Alternatively, only the OCC and the OTS would be merged into the new institution (which would also take over the regulatory function of the FDIC, leaving the Fed as the second federal banking regulator). The latter approach was suggested by Chairman Greenspan, who explained to Congress that the government's proposal would, among other things, lead to an end of the dual banking system, because the FBC, having responsibility both for national and state banks, would be biased in favour of national banks. Furthermore, Greenspan put forward arguments in favour of the continued direct involvement of the Fed in supervision, such as bringing in the macro-economic perspective and a more positive attitude towards risk-taking or having more "clout" in crisis management. The Fed would thereby make a better contribution to the long-term health of the American economy than would a "monolithic" risk-averse supervisor outside the central bank. Reducing the number of federal supervisors from four to two would bring more than proportionate gains in efficiency, although further reducing it to one would compromise other public policy goals.

The need for a direct regulatory role of the Fed was questioned by quite a number of experts during the congressional hearing, some of them accused the Fed of only defending regulatory turf. Others, however, explicitly spoke out in favour of the continued direct supervisory role of the Fed. The latter stressed in particular the need to preserve the "creativity" of the dual banking system. In the end, the government's calls for quick action to modernise the supervisory structure were less convincing to Congress than the risk of changing established structural features of the US financial system (dual banking system, regulatory role of the Fed). The Fed was seen as an ally in the defence of the interests of the state banks against their national bank competitors, although the government tried hard to convince Congress that the dual banking system was not at risk by pointing, inter alia, to the fact that the OTS supervised both federal and state thrifts.

After the renewed failure to reform banking supervision, Congress turned its attention to the repeal of the McFadden-Act, which prohibited interstate branching, and the discussion surrounding the reform/repeal of Glass-Steagall. Even after the passage of the GLBA, the issue of reforming the regulatory agencies did not forcefully re-emerge. This was, however, hardly surprising. Following the increasing of the powers of the Fed by Congress and in view of the appreciation by politicians and business of the dual banking system, it would have been difficult to imagine a system that was not formed by at least two federal banking regulators (one for national banks, the OCC, and one for state banks, the Fed or the FDIC). More generally, the widespread mistrust among US citizens of excessive concentration of power also played a role. Finally, the complaints from the banking industry concerning the multiplicity of regulators in the US remained subdued, since market participants seemed to appreciate the choice entailed in the system.

9 CONCLUSIONS

While some describe the US financial system as evolutionary in nature, others consider it to be a "patchwork" or as having been "crisis-built". If one had to build the regulatory structure again from scratch, it would probably look quite different from how it looks today. More critical observers argue that having four federal banking regulators that have arisen in response to specific historical circumstances, makes regulation potentially more complicated and less expeditious than it needs to be. Also, the multiplicity of regulators is seen as constituting a risk of leniency vis-à-vis the supervised entities as well as of causing confusion and opaqueness for the consumer. Furthermore, doubts have been expressed as to whether the increasing inter-linkages between banking, insurance and the securities markets are adequately taken into account by the institutional set-up. An institutionally more integrated regulatory/supervisory approach is

considered by many as a better solution to the current structure.

The specific institutional framework of regulation/supervision in the US as it has emerged over time also contains, however, a number of attractive features. It allows for regulatory competition under a system of checks and balances, facilitates the achievement of uniform conditions for cross-border financial activity and potentially provides for flexibility to adapt to changing market conditions.

Elements of regulatory competition are introduced into the system, inter alia, by the fact that banks can choose between a state and a national charter. Moreover, state banks – with regard to their federal supervisor – can opt either for direct supervision by the FDIC or by the Fed. The regulatory competition introduced by these elements of choice is, however, not unrestricted. Indeed, while Congress has delegated regulatory powers to specialised agencies, it can at any point intervene in the process and regulate itself. Likewise, Congress can overrule any state legislation. In particular, these checks and balances (delegation of powers to agencies, state competences and federal level prerogatives) make the US regulatory/supervisory system attractive in various respects both from a market and regulatory point of view.

– First, the potential threat of losing regulated entities to "competing" regulators is a powerful incentive for regulators to avoid overregulation and to be responsive to the specific needs of regulated institutions and evolving markets. In this way, risk-taking and innovation are encouraged in the financial system.

– Second, the greater closeness to the market need not come at the expense of the quality of regulation and supervision. In fact, the risk of a race to the bottom is constrained by the above-mentioned power of Congress to legislate at any time against state laws and/or to withdraw rule-making authority from regulatory agencies.

The possibility for the federal level to intervene is not only crucial in areas where Congress traditionally fulfils a legislative role, such as banking, but also in areas where there is no federal legislation, but instead a free choice of state law and mutual recognition, such as in US corporate law. In this case, the "intervention capacity" of the federal level provides a powerful incentive for states to provide appropriate regulation. Similarly, state regulation of the insurance business, for example, has to constantly prove its appropriateness given increasing economic integration. Consequently, state insurance commissioners strive to co-operate effectively under the threat of the introduction of federal regulation or of an optional federal insurance charter.

– Third, the prerogatives of the federal level in the US and the availability of a "national charter" support the creation of uniform legal conditions for banks with cross-border activities. In the US, federal authorities may remove barriers for cross-border activities without the need to involve the individual states in decision-making. Thus, the OCC's pre-emptive power benefits national banks encountering obstacles arising, for example, from state consumer laws.

– Fourth, the system allows for the flexible adaptation of financial regulation to market conditions. This is mainly due to the fact that the degree of direct involvement of political authorities in rule-making is comparatively low. Rule-making by regulatory agencies in the US encompasses rules which in the EU would be considered – at least in part – as framework legislation to be passed by the Council and the EP (e.g. the new capital requirements in response to Basel II).

The risk that the number of agencies involved in rule-making could affect the speed with which harmonised financial rules

are adopted and changed is again kept in check by the congressional power to regulate directly. It constitutes an incentive for agencies to agree to harmonised rules without undue delay.

The flexibility to change the financial framework in the US also affects the institutional structure. From a legal point of view, Congress could merge or abolish regulatory agencies, or create completely new ones at its discretion. However, in practical terms, a fundamental redesign of institutional structures is difficult to achieve while credible institutions (e.g. the Fed) oppose such changes. So far, the numerous attempts to streamline the regulatory structure in the US have failed. However, Congress authorised the Fed to act as an umbrella supervisor over financial holding companies as a necessary corollary to the formation of financial conglomerates allowed under the Gramm-Leach-Bliley Act.

Overall, the US regulatory framework can be described as a system of controlled regulatory competition, with Congress exercising an oversight role while retaining ultimate authority. With regard to the EU, it should be noted that minimum harmonisation and mutual recognition, if properly applied, provide room for regulatory competition among Member States. In the EU context, regulatory competition may be regarded as a potential force for achieving a level playing field on the financial market. However, since mutual recognition does not work in a satisfactory way, it may take some time to achieve such a legal level playing field.[113]

Moreover, the role of the EU decision-making bodies in financial markets regulation – the Council and the EP – is different from that of Congress. As there are no US-style regulatory agencies in the EU,[114] the Council and the EP continue to be more involved in detailed legislation than Congress.

With the Lamfalussy process, the EU has embarked on a strategy to speed up financial market regulation, make it more adaptable to changing market trends and to provide for a level-playing field through convergent implementation. This strategy undoubtedly goes in the right direction and seems to fit the specific "constitutional order" of the EU. Despite this progress, some of the above-mentioned features of the US model, such as the prominent role of regulatory agencies, controlled regulatory competition and the federal power to create uniform conditions may provide inspiration for further improvement of the institutional structures in the EU. It should, however, be noted that implementation of these elements may require the EU to become more similar to the US as a political entity, which is a fully-fledged federal state, where the federal level operates largely independently from the state level. In the EU, Member States can be expected to continue to play a dominant role in shaping EU policies, even if ratification of the Constitutional Treaty would bring about a further strengthening of the European Parliament.

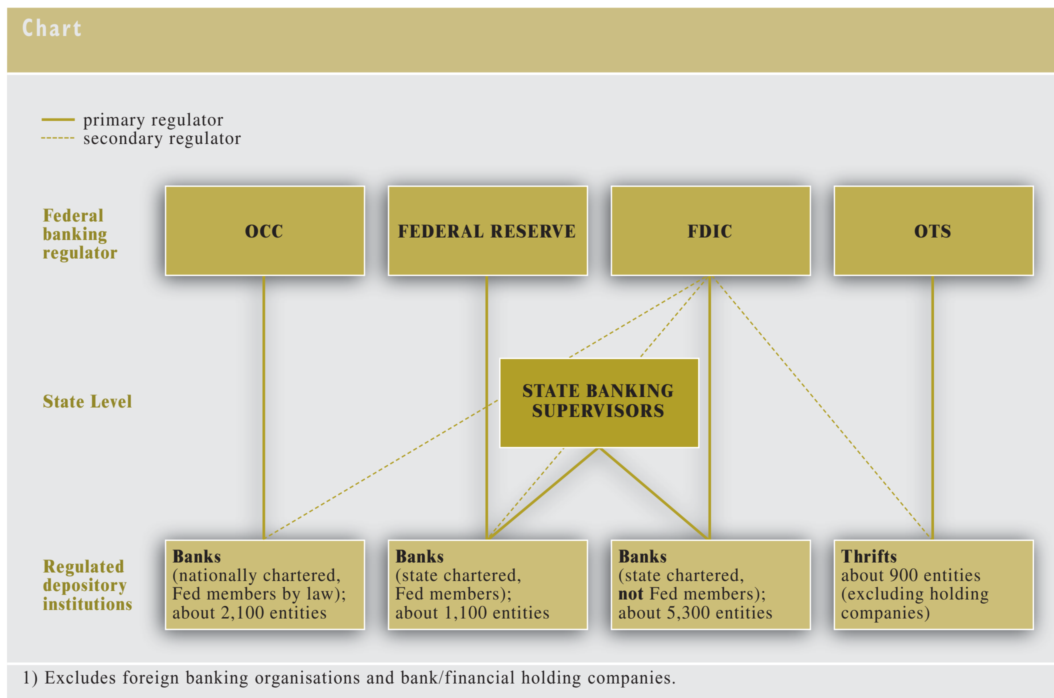
113 Recently, elements of regulatory competition have been reinforced. In the field of securities, for example, issuers of debt securities may – under certain conditions – have their prospectus approved by an EU securities regulator other than the one of the home country. Regulatory competition may also increase as companies may opt for the European Company Statute and as their mobility will be facilitated by the forthcoming EU directives on cross-border mergers and cross-border transfer of registered offices.

114 According to the prevailing school of thought (i.e. the so-called Meroni doctrine), the establishment of US-style regulatory agencies would require an explicit authorisation by the Treaty. Thus, the Council and/or the EP would only be able to create such agencies if the current Treaty (and also the future Constitutional Treaty) were amended empowering them to do so. Another option, already available in Art. 105/6 of the Treaty, would be to entrust the ECB with "specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings." However, any such transfer would, by nature, be of limited scope. Moreover, it would need to be agreed upon in the Council by unanimity.

ANNEX I

STRUCTURE OF BANKING REGULATION IN THE US[1]

Chart



1) Excludes foreign banking organisations and bank/financial holding companies.

ANNEX II

THE FOUR LEVELS OF THE LAMFALUSSY PROCESS[115]

LEVEL I

Community legislation adopted by the Council and the European Parliament, upon a proposal by the European Commission under the co-decision procedure: legislation should be based only on framework principles and definition of implementing powers for the Commission.

LEVEL II

Community legislation adopted by the Commission to lay down the technical details for the principles agreed at "Level I" under the so-called comitology procedure. Particular features:

- Technical advice prepared by the Level III-committees (CEBS, CESR, CEIOPS)[116], following mandates issued by the Commission and based on consultation with market users;

- Favourable vote of Member States (qualified majority) as represented in the Level II-committees (EBC, ESC, EIOPC, EFCC);[117]

- European Parliament may adopt resolutions a) within three months of the draft implementing measure; b) within one month of the vote of the Level II-committees if Level II-measures go beyond implementing powers.

LEVEL III

Level III-committees (CEBS, CESR, CEIOPS) in which the national supervisory authorities are represented, to facilitate consistent day-to-day implementation of Community law. They may issue guidelines and common, but non-binding, standards.

LEVEL IV

Commission checks compliance of Member State laws with EU legislation. If necessary, it takes legal action against Member States before the Court of Justice.

115 Based on Inter-Institutional Monitoring Group (2004), p. 49.

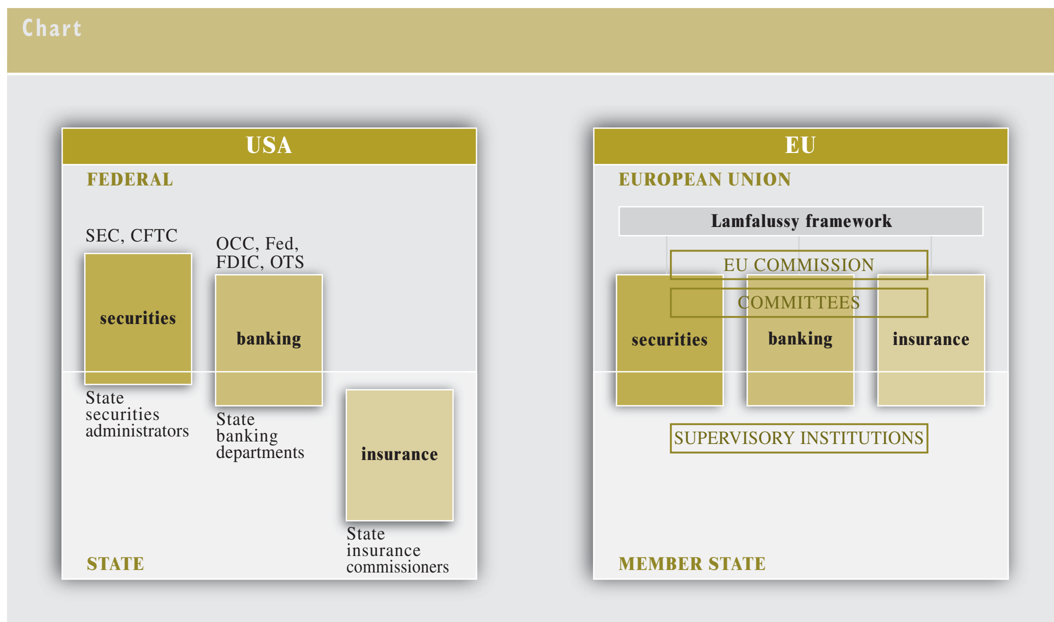
116 Committee of European Banking Supervisors (CEBS), Committee of European Securities Regulators (CESR), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

117 European Banking Committee (EBC), European Securities Committee (ESC), European Insurance & Occupational Pensions Committee (EIOPC), European Financial Conglomerates Committee (EFCC).

ANNEX III

REGULATORY AND SUPERVISORY STRUCTURE IN FINANCIAL MARKETS – STYLISED OVERVIEW

Chart



ANNEX IV

TOP 50 US BANKS (TOTAL ASSETS IN BN USD AND PRIMARY FEDERAL SUPERVISORS[1])

Table

	OCC	Federal Reserve System	FDIC
1 Bank of America, Charlotte	740		
2 JP Morgan Chase	661		
3 Citibank	651		
4 Wachovia Bank	380		
5 Wells Fargo Bank	362		
6 Bank One, Chicago	259		
7 Fleet National Bank	209		
8 U.S. Bank	192		
9 Suntrust Bank		126	
10 HSBC Bank	118		
11 State Street and Trust Company		96	
12 Bank of New York		90	
13 Keybank	77		
14 Branch Banking and Trust Company			73
15 PNC Bank	71		
16 Merrill Lynch			69
17 Bank One, Columbus	69		
18 Lasalle Bank	61		
19 Fifth Third Bank, Cincinnati		60	
20 MBNA America Bank	58		
21 Citibank (South Dakota)	54		
22 Chase Manhattan Bank USA	54		
23 Southtrust Bank		53	
24 Comerica Bank		52	
25 Manufacturers and Traders Trust Company		52	
26 National City Bank	51		
27 Charter One Bank	50		
28 Amsouth Bank		49	
29 Regions Bank		46	
30 Union Bank of California	46		
31 Standard Federal Bank	41		
32 Bank of Amercia, Phoenix	41		
33 National City Bank of Indiana	39		
34 Fifth Third Bank, Grand Rapids		38	
35 Wells Fargo Bank		38	
36 Union Planters Bank	34		
37 Treasury Bank	33		
38 M&I Marshall & Ilsley Bank		33	
39 Northern Trust Company		33	
40 Deutsche Bank Trust		32	
41 Bank One, Delaware	31		
42 Bank of the West			31
43 Huntington National Bank	31		
44 Citizens Bank of Massachusetts			30
45 Banknorth	28		
46 Citizens Bank of Pennsylvania	28		
47 Washington Mutual Bank			28
48 First Tennessee Bank	28		
49 Compass Bank		27	
50 Capital One Bank		27	
Total	**4,497**	**852**	**231**

1) As of 30 September 2004; the top 50 banks represent about 70% of all commercial banks' assets.
The table has been updated with regard to JP Morgan Chase which is in the process of changing to the national charter.

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