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Working Paper

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Working Paper, No. 2011-6

Provided in Cooperation with:

Federal Reserve Bank of Atlanta

Suggested Citation: Wall, Larry D.; Nieto, María J.; Mayes, David (2011) : Creating an EU-level supervisor for cross-border banking groups: Issues raised by the U.S. experience with dual banking, Working Paper, No. 2011-6, Federal Reserve Bank of Atlanta, Atlanta, GA

This Version is available at:

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Creating an EU-Level Supervisor for Cross-Border Banking Groups: Issues Raised by the U.S. Experience with Dual Banking

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Working Paper 2011-06
March 2011

Abstract: The European Union (EU) has been facilitating the growth of cross-border banking groups, but bank supervision remains the responsibility of national supervisors. This mismatch has long been recognized and various proposals have been offered to address this weakness. An alternative that would retain the most important advantages of full centralization is that of centralization only for those cross-border groups that are systemically important. All other banks would remain national responsibilities. To identify some of the issues (but not necessarily the best answers) raised by partial centralization in the EU, we look to the dual banking arrangements in the United States, which has long had both federal and state charters. One issue is that of who qualifies for and/or is required to adopt an EU charter. The U.S. policy of low-cost chartering changes encourages both good and bad competition among supervisors. A second issue is that of the potential mismatch between EU responsibility for prudential supervision of some banks and national provision of deposit insurance and lender of last resort services for all banks. A third potential issue is who should provide business conduct regulation.

JEL classification: G28, F36, K23

Key words: cross-border banking

The authors thank the participants in the Symposium on Managing Systemic Risk organized by the University of Warwick, April 7–9, 2010, for their useful comments. The views expressed here are the authors' and not necessarily those of the Banco de España, the Federal Reserve Bank of Atlanta, or the Federal Reserve System. Any remaining errors are the authors' responsibility.

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Creating an EU Level Supervisor for Cross-Border Banking Groups: Issues Raised by the U.S. Experience with Dual Banking

The European Union (EU) has been facilitating the growth of cross-border banking groups with considerable success, but bank supervision remains the responsibility of national supervisors. The difficulties this poses have been vividly highlighted by the problems encountered in the present crisis that have increased moral hazard. The conundrum has long been recognized and various proposals have been offered to address this weakness, ranging from full centralization of prudential supervision (Pratti and Schinasi, 1999) to strengthened cooperation via colleges of supervisors and resolution authorities (Mayes, Nieto and Wall 2008). An alternative that would retain the most important advantages of full centralization is that of centralization of chartering and supervision only for those cross-border groups that are systemically important to the EU. All other banks would retain national chartering and supervision. In many respects this would be similar to the arrangements in the United States where there are federal and state charters.

Decressin and Čihák (2007) also consider a system with both an EU charter and a national charter. However, they leave open the question of the structure of the prudential supervisor including the possibility that EU chartered banks would be supervised by national authorities. A key part of their proposed framework would be freedom of choice for banks between national and European charters. In the authors' view, this would deliver a prudential level playing field (all banks would have the choice) and allow market forces to play a role in determining the optimal mixture of EU-level and national-level prudential frameworks. Hertig, Lee and McCahery (2009) propose that Member States should have the option to delegate the supervision of banks that pose EU wide prudential risks to the European Central Bank (ECB) under an opt-in approach. The opting in process would require a Member state to enter into a binding agreement with the ECB, which would spell out coordination and cooperation in normal

times as well as in periods of crisis, and which may also contain Member state specific provisions.

In contrast with these prior discussions of two charter types in Europe, this paper explores the idea of an EU level supervisor that could supervise all systemically important cross-border banking groups without requiring an opt-in by the bank's home country. In this respect, the European supervisory system would work somewhat like that in the United States which has long operated under a dual bank chartering system that allows banks to choose between charters issued by the federal government and charters issued by the state government. In the U.S. a bank's choice of charter determines its choice of bank supervisor(s). The U.S. experience suggests that a system with dual charters requires careful consideration of the boundaries between authorities at different levels. This study focuses on three boundaries that would be important to Europe: (a) the criteria for eligibility to the EU charter and the possibility of arbitrage between charters; (b) who would take responsibility for providing the safety net and (c) the interaction between the dual charter and the national business conduct regulation.

We do not advocate for or against Europe's adoption of the U.S. policies on any of the various issues and/or an EU Level supervisor against the background of the US experience. U.S. policies have been tailored to the U.S. political and financial systems as they have evolved through time. What the U.S. experience can do is help to identify the more important issues and demonstrate some of the consequences of some possible solutions.

The rest of the paper is organized as follows: Section 1 briefly reviews the origin of the US dual banking system in contrast with the EU institutional framework for supervision. The regulatory issues raised by the dual charter are analyzed in section 2, where we explore what could be the criteria for eligibility for an EU charter and the chartering authority; whether some

or all banks that qualify for an EU charter be required to convert to an EU charter and under what circumstances could a bank with an EU charter be allowed to convert back to a national charter. The issues raised by the lack of an EU-level safety net are also analyzed in this section that explores alternatives that would return control over their fiscal exposure to the Member States. Lastly, this section discusses issues associated with preemption in the business conduct regulation. We conclude and present policy implications in the last section.

1. Background

The creation of an EU level supervisor for cross-border banks has become a somewhat more intellectually attractive solution to the supervision of these banks in the EU in the light of the experiences in the autumn of 2008 and the institutional changes in supervision agreed by policy makers. The EU level banking supervisor should have full authority over the banking group as a whole, including the required information and powers to act should any problem be detected, with a mandate to protect the financial stability of each country in which the group operates. Such a system would allow for continued differences in the supervision of groups that are, at most, of systemic importance to their home country while focusing a new EU level supervisory agency on the cross-border banking groups. The cross-border banks we are referring to are those where at least one host country regards its operations as being of systemic importance, i.e. its failure would be a threat to financial stability.¹ However, the creation of such a dual supervisory system at national and EU levels would also raise a number of new issues. Among these issues are a set of concerns relating to the relationship between the two levels of supervisors (agencies), and with investor protection regulators (whether a separated agency or

¹ We intentionally avoid having to define what is “systemic” for the purpose of this paper.

not of the prudential supervisor); how the two levels of supervisors would work with the agencies running the safety net — the deposit insurers and lenders of last resort.² Clearly unless the EU-level agency is in charge of systemic concerns for every Member State of the EU there is a potential problem of coordination with the national agencies that have that task. Furthermore, given the absence of any noticeable ability to make fiscal transfers and other adjustments, such as investment, that would ease the impact of regional shocks as in the US, the need for treating localized financial instability directly in the EU is much greater than in the present US.³

In contrast to proposals that the EU deliberately adopt a dual chartering system, the U.S. dual banking system was an unintended consequence of the creation of the National Banking System in 1863 to help fund the Union effort in the U.S. Civil War by increasing demand for government bonds.⁴ The federal charter was not created to facilitate interstate banking; the legal changes to facilitate widespread interstate commercial banking were not adopted until the 1980s. Nor was the federal charter created to control safety net subsidies better. The modern U.S. lender of last resort was created by legislation passed in 1913 and the U.S. deposit insurance system

² We deal here with the more tractable proposition of banks that are headquartered and operating in the EU/EEA. If banks are headquartered further afield or have major activities elsewhere, the problem will remain difficult to handle without a supranational agency in charge and better alignment of international bank insolvency legislation.

³ The degree of self-insurance, such as through holding wealth outside the member state, is also lower in Europe than in the US.

⁴ See Calomiris (1989) for a brief discussion of some of the changes due to the National Banking Act. The Act imposed a 10 percent federal tax on state-chartered bank notes (currency) to eliminate competition from state chartered banks. This ended state bank issuance of notes but state chartered banks were able to survive by switching to deposit-based banking.

was created by legislation passed in 1933. Instead of the federal charter being created to facilitate change, it is much more the case that these important changes to the U.S. commercial bank regulatory and safety net systems were structured to work within a dual chartering system.

The differences in the origin of dual chartering between the EU and the US do not relate to the issues that must be addressed but to the order. Rather than cross-border banking and safety net policies being developed in consideration of the prior existence of dual chartering as in the US, the EU would need to develop its dual chartering and supervisory policies in the light of existing supervisory and safety net structures.⁵

2. The regulatory issues raised by the existence of a dual charter

2.1 Who is subject to EU level supervision?

The U.S. regulatory system mixes elements of state and federal supervision. State banks are subject to federal supervision by one of two federal agencies as a condition for being insured by the Federal Deposit Insurance Corporation (FDIC) while all national banks are subject to supervision a third agency. There are additional complications in the U.S. supervisory structure but these exist for a variety of historical and political reasons that are not relevant to Europe.⁶ For

⁵ In related work, Kahn and Santos (2005) analyze the consequences of the allocation of lender of last resort and supervisory functions in the euro area for the degree of forbearance in closing distressed banks and for the level of diligence in bank supervision and Hardy and Nieto (forthcoming) study the optimal design of supervision and bank crisis resolution in a multicountry setting, with an integrated banking market, such as the EU, where policy-makers have either similar or asymmetric preferences regarding profitability and stability of the banking sector.

⁶ Commercial Banks may choose between a national (federal) charter with supervision by the Office of the Comptroller of the Currency or a state charter. State chartered banks may choose between supervision by the Federal Reserve and the FDIC. Additionally, the holding company of all groups owning a commercial bank is supervised by

the purpose of our analysis, what is relevant is that the U.S. system: (a) allows banks to change their charters and supervisors at rather low cost subject to the approval of the new supervisor, (b) the supervisors have used their power in a way that has resulted in almost all of the largest banks selecting a national charter and almost all of the small banks selecting a state charter.

The ability of banks to change their charters at relatively low cost is regarded by most banks as a critical part of the U.S. dual banking system as it encourages the supervisors to use their discretion in ways favorable to each supervisor's clientele of banks. U.S. supervisors discretion is limited as many aspects of U.S. prudential supervision are established by statutes and regulations that are virtually identical for all commercial bank supervisors, such as for the capital adequacy requirements. However, the various supervisors retain some important discretion over the writing of some regulations, such as in the range of financial products that may be offered, and the supervisors also have some discretion over the implementation of the various regulations.

One of the advantages claimed for supervisory competition is that it discourages unnecessarily restrictive regulation. Bankers cite cases where the state supervisors denied banks permission to engage in a new activity which was authorized by the federal supervisors (or vice versa with state supervisors approving the activity). Another advantage is that it puts pressure on

the Federal Reserve. Any holding company owning a thrift (savings bank) but not a commercial bank is supervised by the Office of Thrift Supervision (OTS). The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act will abolish the OTS and distribute its supervision of thrifts to the FDIC and OCC, and its supervision of thrift holding companies to the Federal Reserve. This complication of multiple federal supervisors and distinctions among financial institutions that are all regarded as being banks in the EU would not need to be repeated in a European equivalent of the US system.

supervisors to be efficient. State supervisors and the national bank and thrift supervisors depend on fees collected from their banks to fund their operations.⁷ If banks start changing charters that raises the revenue of the supervisor gaining the charter and lowers the revenue of the supervisor losing the charter.

Conversely, opponents of the dual banking system accuse it of promoting competition in laxity. Wilmarth (2004) argues that the Office of the Comptroller of the Currency (OCC) has tried to get state chartered banks to adopt a national charter by promoting its ability to preempt stricter state business conduct regulation. Appelbaum and Nakashima (2008) discuss how the OTS's efforts to increase the agency's revenues by expanding its set of regulatees led to weak prudential supervision.⁸ In one particular case, Countrywide, the OTS induced a national bank regulated by the OCC to change to a federal thrift charter.⁹

In theory national supervisors in the EU could compete for national bank charters under current legal framework only subject to the requirement of minimum harmonization imposed by the Banking Directive. Under the "single passport" concept, a bank that is properly authorized in any EU country may branch into any other EU country. In principle, a bank that found its home country supervisors too strict, could move its charter to a more accommodating country,

⁷ The FDIC and Federal Reserve do not charge fees but depend on other sources of income.

⁸ Appelbaum and Nakashima (2008),

⁹ Appelbaum and Nakashima (2008) quote a former Countrywide executive as saying "The general attitude was they (the OTS) were going to be more lenient."

provided that the change was approved by the bank's new home country.¹⁰ Indeed, in theory the degree of regulatory competition in the EU could be far greater than among states in the U.S. While banks in the U.S. can change supervisors, virtually all U.S. banks have to comply with federal laws and regulations. In contrast, in the EU, such changes can take two forms. The bank could move its headquarters and main operations to a different Member State or it could become a European Company under the European Company Statute.

In practice, moving charters is not so easy in the EU. While banking laws may not prohibit movements, a variety of other considerations such as language, national traditions, taxes, deposit insurance payments and the franchise value greatly raise the cost of transferring charters.

While the U.S. dual banking system was not started with present circumstances in mind it has continued in part as a way of inducing lower cost supervision. The U.S. system allowing banks to pick their own charter and change charters at minimal costs reflects this goal. An EU dual charter system would start with a different goal, that of better supervising systemically important cross-border groups. This difference in goals suggests that were the EU to adopt a dual charter, it would need to address three chartering questions from the perspective of improved cross-border supervision:

- (1) What are the criteria for eligibility for an EU charter?
- (2) Will some or all banks that qualify for an EU charter be required to convert to an EU charter? And,

¹⁰ In the EU, competition might act in the opposite direction, with many banks preferring to have their quality recognized by being subject to the more stringent authority.

(3) Under what circumstances, if any, will a bank with an EU charter be allowed to convert back to a national charter?

The answers to these questions will determine the effectiveness of the EU Charter including the extent of competition and possibilities of arbitrage between national and EU level supervisors.

2.1.1. Criteria for eligibility.

The criteria for eligibility for an EU charter could be subjective (such as colleges of supervisors' assessments of systemic importance)¹¹ or objective (such as market share, size or presence in several EU countries). A narrow set of criteria would start with the extent to which the bank has cross-border operations either via presence (branch or subsidiary) or operations (interbank, foreign exchange (FX), and/or derivatives markets). Another consideration might also include the absolute size or market share of the group as a proxy for its systemic importance to the EU. A third consideration would be the number of the countries in which the group is systemically important as per the decision made by the college of supervisors. The CRD envisages that colleges of home and host country supervisors do need to decide on the systemically important character of both branches and subsidiaries and it provides some guidance in Art.42a(a) in this respect.

2.1.2 Must eligible banks convert?

¹¹ The Capital Requirement Directive (CRD) establishes that prudential supervisors of host and home countries decide jointly on the designation of branches and subsidiaries as being systemically important in the host country. The consolidating supervisor shall take account of the potential impact on the stability of the financial system in the Member States.

Once the various EU chartering criteria are satisfied, the question arises as to whether conversion to an EU charter would be mandatory and who would be the chartering authority. If the goal of creating an EU level supervisor is to address the problems of supervising and resolving cross-border groups better, the answer would appear to be that all groups meeting the established criteria would be required to convert to the EU charter. This will leave room for competition at the start as some groups may be able to restructure themselves in a way that allows them to retain national supervisors. Even more competition will arise, if conversion is not mandatory. Regulatory competition, however, would be limited by the EU centralized authority on Competition. Nonetheless, in order to limit the incentive to arbitrage between charters there is an economic rationale for calibrating the EU Charter at a level that makes this charter attractive for Europe's major cross-border banks, for example, establishing a Single Special Resolution Regime for the EU Chartered Banks that reduces the coordination costs among national resolution authorities. Moreover, certain prudential regulation with a marked national character such as countercyclical capital buffers that would apply to EU Chartered Banks would reflect the geographic composition of the bank's portfolio of exposures and calculate their variable buffer add-on as a weighted average of the add-ons which are being applied in Member States to which those banks have an exposure.

2.1.3 Converting Back

Once cross-border banking groups have taken an EU charter, a further question is whether they would be allowed to convert back to national charters. The answer to this question may seem obvious if some institutions are required to convert to an EU charter, they obviously would not be given permission to convert back to a national charter. However, consider the case where the group no longer satisfies the criteria for an EU charter. A group may no longer meet the criteria

because of a deliberate decision to sell or spin off part of its operations (e.g. banks that received government capital injections have been required by the EU competition authority to divest lines of business and financial affiliates). Or it may be that the group is shrinking relative to the requirements for an EU charter. Were any of these to happen, should the group be required to retain an EU charter, required to convert to a national charter or given the option to convert back to a national charter? When the groups do not meet the criteria that supervisors established to grant the EU Charter (e.g. bank has been restructured in the aftermath of a crisis), the bank will want to shift to a national charter more suitable for its new structure. If conversion back to a national charter is envisioned, the frequent charter switches should be discouraged by requiring that the group not just fail the minimum criteria for an EU charter but that it must fail the criteria by a substantial margin. Another way to prevent frequent switches would be to require that the bank fail the criteria for more than a certain number of years before being allowed to convert back to a national charter.

2.2 Who is responsible for providing the safety net?

The U.S. did not have an official lender of last resort or national deposit insurance system at the start of the dual banking system.¹² However, commercial-bank clearinghouses in some major cities provided a sort of lender of last resort and accompanied it with some bank supervision from the 1850s through to the creation of the Federal Reserve according to Gorton and Mullineaux (1987). While clearinghouses were valuable in mitigating the impact of bank panics, they in effect required private institutions to provide a public good in the form of reduced

¹² Calomiris (1989) notes that three states' insurance programs predating the National Banking Act continued in operation until 1865 or 1866.

financial instability. After the Panic of 1907, some major New York banks determined that the private costs of providing this public good exceeded these banks' share of the gains according to Moen and Tallman (2003). The Federal Reserve Act of 1913 provided for the new central bank to lend on good collateral to its member banks. The Act required national banks to become members. The Act also allowed state chartered members to become members of the Federal Reserve, but required as a condition of membership that state-chartered member banks (state member banks) submit to Federal Reserve supervision, including on-site examinations.¹³

Deposit insurance during the dual banking era initially took the form of state-run deposit insurance systems adopted by eight states in the early 1900s according to Calomiris (1989). All eight of these state plans were exclusively for banks chartered by that state. All eight of these systems collapsed with the waves of bank failures in the 1920s and early 1930s.¹⁴ Federal deposit insurance started with the creation of the (FDIC) by the Banking Act of 1933. That Act required Federal Reserve member banks (national and state member) to join the FDIC. State non-member banks, that are banks which had not been subject to inspection by federal bank supervisors, were authorized to join the FDIC but only after examination and approval by the FDIC.¹⁵ The Banking

¹³ The all or nothing bargain offered to state chartered banks also included other benefits and costs for joining the Federal Reserve. The sets of benefits and costs unique to Federal Reserve membership have been reduced over time so that the primary remaining benefit and cost is that of Federal Reserve supervision for state member banks.

¹⁴ Calomiris (1989) argues that flaws in the structures of these programs were important factors in their collapse. In particular, he pointed to the fact that the eight state programs provided their member banks with weak incentives to monitor each other.

¹⁵ FDIC (1984), [Chapter 3](#).

Act of 1935 gave the FDIC the power to terminate a bank's insured status.¹⁶ This was a draconian penalty that, when invoked, would typically result in the bank's closure.

Thus, the pattern in the U.S. is clear. The entity providing lender of last resort or deposit insurance was generally provided with the authority to examine and discipline the banks to which it had contingent financial exposure. The Federal Reserve was created when the clearinghouses became exposed to decisions of trusts that were not part of the clearinghouse. Federal Reserve lending was initially limited to member banks. Individual state deposit insurance systems were limited to banks chartered by that state. The FDIC was given the authority to examine banks before they became members and later given the authority to terminate a bank's deposit insurance.

Both the Federal Reserve and FDIC are exposed to losses at institutions for which they are not the primary federal supervisor, however, both are provided with tools to mitigate their risk exposure. Both agencies have access to the examination reports filed by the other two federal regulatory agencies. The Federal Reserve's exposure to national banks and state non-member banks is tempered by the requirement that its loans be secured by acceptable collateral. The Federal Reserve Banks are authorized to require any information they need to satisfy themselves that the collateral is acceptable.¹⁷ For those institutions where the FDIC is not the primary supervisor, the agency has backup examination authority.¹⁸

¹⁶ FDIC (1984), Chapter 6.

¹⁷ 12 Code of Federal Regulation 201. <http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=de1a245501fa2479f877eb5242fbcf65&rgn=div5&view=text&node=12:2.0.1.1.2&idno=12#12:2.0.1.1.2.0.1.3>

¹⁸ Coburn and John P. O'Keefe (2003)

In the EU, while it may be possible to create an EU level prudential supervisor for cross-border banking groups, responsibility for safety net provision will almost surely remain a national responsibility for the foreseeable future. The primary difficulty in shifting safety net responsibility to the EU is that the EU lacks taxing authority; that power remains lodged in its Member States. Buiter (2008) argues that the lack of backing by a fiscal authority could be a problem for a central bank as the collateral it takes for its loans may turn out to be worth less than the value of its loans. He notes that while individual Member States stand behind their national central bank, no fiscal authority stands behind the ECB. However, the national central banks are the shareholders of the ECB and should they need to subscribe more capital they can call on their respective governments.¹⁹

While the lack of fiscal support is of debatable importance for the central bank, it represents a clearer concern for deposit insurance agencies. Even agencies that have accumulated an *ex ante* fund may find the funds are inadequate during peak loss periods, as has happened in the U.S. with the Federal Savings and Loan Insurance Corporation (FSLIC) and may happen with the FDIC during the current global financial crisis. However, contingent funding from Member States could be set up pending replenishment of the fund by the industry after the crisis. More difficult would be covering *ex ante* the sort of bailout financing that has been used in some countries in the present crisis (the divestures required by the EU Competition authority is a good example of bank restructuring aimed at repaying the government fiscal support). Even *ex post*

¹⁹ In practice this problem is rather unlikely as the lender of last resort function is disaggregated in the Eurosystem and even with credit easing operations of the ECB it is relatively unlikely that it would need recapitalizing given its conservative collateral policy but it is inherent in crises that problems that have not been thought likely do occur.

they may be on scale where repayment by the banking industry or by private purchasers of nationalized assets becomes a very drawn-out process if it is not to create a prolonged recession along the way. One alternative for dealing with high cost events that are (hopefully) low probability would be to implement a version of Wall's (1997) proposal that the FDIC issue contingent capital. Wall's (1997) intent was merely to provide market signals on the condition of the FDIC fund, but his proposal could be expanded to provide the deposit insurer with access to private funding should it suffer unexpectedly large losses.

Thus, the creation of an EU level supervisor threatens to create a situation where the member state providers of the safety net do not have direct control over parts of their loss exposure. The potential problems with this are both economic and political. The economic problem is that of a principal (the voters and taxpayers of a member state) that has no direct control over that of an agent. In practical terms, this means that an EU level prudential supervisor may assign lower priority to minimizing taxpayer losses of a particular country than would be the case if the supervisor were accountable to the taxpayers of the responsible country through that country's political system. The political problem is the lack of a fully binding ex ante commitment on the part of the national governments to provide funding as necessary. The voters and taxpayers of a country may refuse to bear the fiscal burden of large financial crisis over which neither they nor their elected representatives had total control. Such a refusal is more likely to the extent that the EU level supervisor is perceived to have failed to perform its supervisory duties adequately.

One alternative that would return control over their fiscal exposure to the Member States would be to adopt the approach taken by the Federal Reserve and FDIC with regards to banks they do not directly supervise. That is, give the national central bank, supervisor and national

deposit insurers the power to: (1) request additional information, (2) undertake their own backup examinations, and (3) where appropriate to deny the loan or terminate the insurance coverage.²⁰

The first two powers are consistent with an EU Level prudential supervisor that operationally relies on a network of national supervisors. This is not a perfect solution from the perspective of the national safety net authorities or the EU level supervisor. The national safety net authorities are still somewhat dependent upon the EU Level supervisor to decide to take action when a cross-border banking group encounters financial problems. However, from the EU supervisor's perspective, alerting national safety net authorities could be problematic. The problem is that the national authorities could take actions (such as starting reorganization and winding up proceedings or terminate deposit insurance of a distressed subsidiary bank) that could aggravate the banking group's problems at a time when the EU level supervisor believes it still has a good chance of returning to health. Without such national backup powers, the situation is in many ways analogous to the current situation where the Member States' are exposed to losses arising from cross-border banks and banking groups over which they have little or no supervisory power.

This discussion emphasizes the importance of a set of issues that are largely outside the scope of this paper, that of the changes made for EU supervised banks that would reduce both the probability of failure and the cost should a major cross-border bank fail. Hopefully those losses would tend to be smaller because a single EU supervisor could eliminate the coordination

²⁰ The deposit insurer would need to give advance notice of its intention to terminate deposit insurance, as is the case for terminations by the FDIC.

problem among national supervisors and may be less likely to forbear.²¹ Alternatively, the EU Charter could also encompass a Single EU Special Resolution Regime for large cross border banks administered by either the EU level supervisor or a centralized resolution agency. Such Special Resolution Regime would minimize the cost of resolving a failed banking group by a coordinated reorganization/winding up of all banking entities of the group (Nieto, 2010; IMF, 2010).²²

2.3 *Business Conduct Regulation*

The United States has had a long-running dispute over the ability of its states to impose business conduct regulation on federally chartered financial firms. U.S. federal courts have generally held that business conduct regulation of federally chartered depositories (commercial banks and thrifts) is the exclusive province of the federal government, in U.S. terms that federal law preempts state law.²³ However, state and local governments have periodically sought to enforce their conduct regulations when they perceive federal rules to be too weak or inadequately enforced.²⁴

²¹ Indeed there are strong reasons for thinking it may be less likely to forbear than national supervisors simply because it avoids the problems of free-riding by some Member States in the hope that others will eventually tackle the problem for the entire group (Nieto and Hardy, forthcoming, inter alia). Whether it is in practice will depend in large part on the governance arrangements for the new EU level supervisor.

²² However, achieving this orderly resolution could be difficult under current legal differences across the Member States (Garcia et al., 2009).

²³ This section focuses on regulations specific to the financial sector. State laws applicable to the conduct of business in general, such as their commercial codes, apply to all banks, regardless of whether it has a federal or state charter.

²⁴ The Obama administration's regulatory reform proposal included provisions that would allow states to impose and enforce laws that are tougher than federal standards. However, while the recently adopted Dodd-Frank Wall

This presents a problem that does not exist in the EU at present. While cross-border banks operating directly or through branches are subject to home country prudential control they are subject to host country conduct of business and consumer protection rules. We explore the experience of the US in order to consider the relative advantages of creating an n+1th conduct of business regime in order to improve the ease of entry into national markets.

One of the rationales for federal banking law preempting state banking law is that states might otherwise impose laws that put federally chartered banks at a competitive disadvantage.²⁵ Another rationale for federal preemption is that change in state laws or their interpretations may

Street Reform and Consumer Protection Act expands state power to enforce business conduct regulation, the changes do not go nearly as far as the administration's proposal.

²⁵ An early test case of federal law, *Tiffany v. National Bank of Missouri*, arose when the state of Missouri imposed a lower loan rate ceiling on banks not chartered by the state of Missouri. If allowed to stand, this law could have put national banks at a substantial competitive disadvantage. The U.S. Supreme Court held that federal law was not intended to allow states to put national banks at such a competitive disadvantage. *Tiffany v. National Bank of Missouri*, 85 U.S. 18 Wall. 409 409 (1873), <<http://supreme.justia.com/us/85/409/case.html>>.

impose losses on the federal safety net.²⁶ A third rational for preemption is that state business conduct regulation may be used to limit competition in that state.²⁷

A fourth argument for preempting state laws is that of greater operational efficiency. In the absence of preemption, national banks would need to tailor their operations in each state to that state's business conduct regulation. Among the possible results could be that application forms, training procedures, and computer systems could all have to be tailored to meet each state's idiosyncratic requirements. With preemption, the bank can implement a uniform procedure for delivering services across its entire network.

The opponents of preemption tend to favor the approach proposed by the Obama administration under which federal business conduct regulations set minimum standards for

²⁶ The Supreme Court of the State of California ruled that the enforcement of certain loan terms was "unconscionable" under California law in certain circumstances according to Mason, et al. (2010). The effect of this decision and similar changes in the laws of other states would have been to impose significant losses on federally chartered savings and loans according to Mason, et al. (2010). In order to prevent this decision from having an adverse impact on federally chartered thrifts, the Federal Home Loan Bank Board preempted the state laws. The U.S. Supreme Court upheld the preemption in *Fidelity Fed. S. & L. v. De la Cuesta*, 458 U.S. 141 (1982).

²⁷ For example, Mason, et al. (2010) note a Massachusetts law that allowed a non-Massachusetts bank to set up an ATM in Massachusetts only if that Massachusetts banks could set up an ATM in that state. However, even where the laws are clearly intended to benefit consumers, their anticompetitive impact may actually be adverse for consumers. As an example, Mason, et al. (2010) point to municipal ordinances in San Francisco and Santa Monica that banned banks from charging ATM fees to customers of other banks. Such regulations reduce the charges to consumers when they are able to access an ATM owned by another bank. However, these laws also have the effect of limiting consumers' access to ATMs, both by encouraging banks to limit ATMs to their own customers and by discouraging banks from placing ATMs in new locations.

federally chartered banks but states should have the option of writing and enforcing tougher standards. Consumers Union (1998) gave a list of state measures intended to “protect ... constituents from unfair banking practices and escalating fees” that were rendered less effective and in some cases effectively blocked by federal preemption.²⁸ Another argument that opponents of preemption make is that allowing federally chartered institutions to avoid state regulation may undercut states’ ability to enforce consumer regulations on state chartered institutions. In part this argument arises because the federal chartering authorities are competing to attract existing and potential future state chartered institutions to adopt federal charters. The federal authorities may make the federal charter relatively more attractive by implementing less strict regulations. Indeed, Wilmarth (2004) references comments by then Comptroller of the Currency Hawke as touting the OCC’s ability to preempt state consumer laws as one of the advantages of adopting a national bank charter. Moreover, the competitive advantages of being able to preempt state law can be so large that a large fraction of the business shifted to federally chartered banks. For example, Furletti (2004) discusses the impact of preemption on the U.S. credit card industry and argues that it helped national banks become by far the largest suppliers of credit cards in the U.S.²⁹

²⁸ This list of state measures highlights a key philosophical difference between most advocates of preemption and most of its opponents. Opponents of preemption tend to view strict government regulation as necessary to protect consumers from making mistakes. In contrast, advocates of preemption tend to view competition as providing the best combination of services and prices to consumers in the long-run.

²⁹ Albeit, in part this is because of the way it allowed national banks to avoid state usury laws at a time when these ceilings had a binding impact on credit card rates. In this case preemption may be regarded as a desirable policy that

The issues associated with preemption in the EU are generally similar to those in the U.S. National authorities might use business conduct regulation to disadvantage EU chartered banks, although this possibility is largely limited by the principle of minimal harmonization, while EU supervisory authorities may use preemption to give their banks a competitive advantage. National authorities may establish laws that “protect consumers from abuses” but their ability to “limit competition” is itself limited because competition is an EU responsibility. Compliance with different national business conduct regulations would definitely reduce the efficiency of EU chartered banking groups.

The weighting of the various advantages and disadvantages of preemption in the EU may differ from that of the U.S. in at least two important ways. First, there are greater differences across the EU in culture and commercial codes than within the U.S. The U.S. does not have a uniform culture nor do all states have exactly the same commercial code. However, the shared history of the states of the U.S. and state efforts to produce a recommended “Uniform Commercial Code” have greatly reduced the differences across the states relative to that of the Member States of the EU. These cultural and legal differences across the EU are likely to extend to some aspects of some financial products. One implication of this is that investors’ expectations of the rules may differ dramatically, implying a greater value to local rules. Another implication is that independent of business conduct rules, cross-border banks in the EU will need to tailor their offerings more to local markets than is necessary in the U.S. — probably reducing the efficiency advantages of the EU Charter.

increased the availability of credit cards to consumers or as undesirable policy that allowed consumers to be “exploited” by excessive credit card rates.

On the other hand, the EU is unlike the U.S. in that it has an explicit goal of a single market in financial services and, hence harmonization also holds for business conduct rules and consumer protection. While in theory such harmonization should be the minimum necessary for an efficient and competitive market, greater integration will eventually need further harmonization. Allowing Member States to impose differential rules on cross-border groups will hinder movement towards that goal.

3. Conclusions and policy implications for the EU

The idea of having an EU-level prudential supervisor for cross-border banks with systemic impact in the EU in addition to national supervisors for the rest of the system has considerable intellectual attractions. It addresses the issue of having a consistent arrangement for the regulation and supervision of such groups for which the principle of minimum harmonization has proved insufficient. Moreover, if the EU-level supervisor also applies a single set of rules rather than simply trying to ensure that the plethora of national rules and supervisory practices are applied and reconciled if they conflict, this could result in considerable simplification and reduction in compliance costs if it is efficiently provided. Additionally, it will solve the problem of the lack of incentives to share information among the national supervisors of the cross-border banks. However, it has the disadvantage that two levels of supervision can be applied in one Member State. We look to the US for evidence on the experience with a dual banking system with two levels of supervision. Here the experience is somewhat mixed as while regulatory competition may encourage supervisors to be efficient in order to attract banks it may also encourage them to be lax or set lower standards. The EU, however, has traditionally used the approach of harmonization to pursue the integration of the financial markets (in any case, the differences in regulation are defined along national lines and do not discriminate between purely

national and cross border banks). Moreover, competition policy in the Single Market is an EU level competence, limiting the possibility of a race to the bottom. More relevant, however, are the potential conflicts when the safety net has to be invoked. In the US the safety net was at federal level even before interstate banking was developed. Solving this analogously for the EU would involve a second EU-level agency unless the EU-level supervisor was also the insurer and resolution authority. This solution would be preferable to coordination problems among agencies that may result in national deposit insurers to be unwilling to pay out or national authorities to fund if they view the problem to be the fault of the EU-level agency.

One aspect of the dual mandate which the EU would be well-advised not to emulate is conduct of business regulation. The EU is harmonizing conduct of business and consumer protection regulation subject to minimum standards with the prevalence of the host country rules. While cross-border banks would be keen to see a single set of rules and providing such rules would no doubt accelerate the process of financial integration this is not something that is key to financial stability. Moreover, competition policy is already centralized in the EU and it is proving to be a powerful restructuring tool.

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