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BANKING REGULATION

OBJECTIVES OF BANKING REGULATION

Banking regulation, like securities regulation, is in part about the maintenance of confidence in aspects of the financial markets. Banking regulators want to avoid bank runs. They want to protect depositors (note that we assume that bank depositors are likely to be more risk averse than investors in securities - they want a safe place for their money rather than an opportunity to make a profit). Banking regulators also want to ensure the safety and soundness of banks as key elements in the payments system.

The **Basle Committee's[1] Core Principles for Effective Banking Supervision** are set out below:

LIST OF CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION[2]

Principle 1 – Objectives, independence, powers, transparency and cooperation: An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Principle 2 – Permissible activities: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.

Principle 3 – Licensing criteria: The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Principle 4 – Transfer of significant ownership: The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

Principle 5 – Major acquisitions: The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Principle 6 – Capital adequacy: Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

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[1] The Basle Committee on Banking Supervision was established in 1974 by the G10 central bank Governors as a forum for co-operation. See http://www.bis.org/about/profforum.htm

[2] The document is at http://www.bis.org/publ/bcbs129.pdf. The updated principles were endorsed by banking regulators from 120 countries in 2006. BIS Press Release, Bank Supervisors from 120 Countries Endorse Updated International Principles for Effective Banking Supervision, (Oct. 5, 2006) available at http://www.bis.org/press/p061005a.htm .

Principle 7 – Risk management process: Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

Principle 8 – Credit risk: Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

Principle 9 – Problem assets, provisions and reserves: Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

Principle 10 – Large exposure limits: Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

Principle 11 – Exposures to related parties: In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

Principle 12 – Country and transfer risks: Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

Principle 13 – Market risks: Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Principle 14 – Liquidity risk: Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

Principle 15 – Operational risk: Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

Principle 16 – Interest rate risk in the banking book: Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior

management; these should be appropriate to the size and complexity of such risk.
Principle 17 – Internal control and audit: Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
Principle 18 – Abuse of financial services: Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.
Principle 19 – Supervisory approach: An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.
Principle 20 – Supervisory techniques: An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.
Principle 21 – Supervisory reporting: Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.
Principle 22 – Accounting and disclosure: Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.
Principle 23 – Corrective and remedial powers of supervisors: Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.
Principle 24 – Consolidated supervision: An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
Principle 25 – Home-host relationships: Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

Applying these principles can be complicated by the intricacies of domestic regulatory systems. As well as the issues of how responsibilities for different areas of financial regulation (securities, banking, insurance etc) may be split between different regulators within different national systems, different countries allocate responsibilities for banking supervision differently. In the

US a number of different federal agencies have responsibilities in relation to banking regulation. The **Office of the Comptroller of the Currency** (OCC)[3] is the primary federal regulator for national banks.[4] The **Federal Reserve Board** (Fed)[5] is the main federal regulator for state-chartered banks which are members of the Federal Reserve System, and the **FDIC** (Federal Deposit Insurance Corporation)[6] is the main federal regulator for state chartered banks which are not members of the Federal Reserve System. Often the federal banking regulators act together[7] in proposing new federal banking regulations, and they are required to report to Congress on differences in their capital standards and accounting standards. The following excerpt is from the regulators' **Joint Report on Differences in Accounting and Capital Standards Among the Federal Banking Agencies**:[8]

Since the agencies filed their first reports on accounting and capital differences in 1990, the agencies have acted in concert to harmonize their accounting and capital standards and eliminate as many differences as possible. Section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4803) also directs the agencies to work jointly to make uniform all regulations and guidelines implementing common statutory or supervisory policies. The results of these efforts must be ''consistent with the principles of safety and soundness, statutory law and policy, and the public interest.'' In recent years, the agencies have revised their capital standards to address changes in credit and certain other risk exposures within the banking system and to align the amount of capital institutions are required to hold more closely with the credit risks and certain other risks to which they are exposed. These revisions have been made in a uniform manner whenever possible and practicable to minimize interagency differences.
While the differences in capital standards have diminished over time, a few differences remain. Some of the remaining capital differences are statutorily mandated. Others were significant historically but now no longer affect in a measurable way, either individually or in the aggregate, institutions supervised by the Federal banking agencies. In this regard, the OTS plans to eliminate two such de minimis differences during 2006 that have been fully discussed in previous joint annual reports ((i) covered assets and (ii)

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[3] http://www.occ.treas.gov

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

[5] http://www.federalreserve.gov/

[6] http://www.fdic.gov/

[7] Together with the Office of Thrift Supervision, http://www.ots.gov/

[8] 71 Fed Reg 16776 (Apr. 4, 2006) at http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-3179.pdf

pledged deposits, nonwithdrawable accounts, and certain certificates), and these differences have been excluded from this annual report. In addition to the specific differences in capital standards noted below, the agencies may have differences in how they apply certain aspects of their rules. These differences usually arise as a result of case-specific inquiries that have only been presented to one agency. Agency staffs seek to minimize these occurrences by coordinating responses to the fullest extent reasonably practicable.

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

Under the **International Banking Act**,[9] a foreign bank which wants to do business in the US is required to obtain authorisation to do so. If it wishes to establish a federal branch or agency it requires the approval of the OCC, if it wishes to establish a state branch, agency or representative office it requires the approval of the Federal Reserve. In practice, foreign banks doing business in the US tend to establish state branches or agencies.[10]

International Banking Act 12 USC § 3105

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

(1) Prior approval required

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

(2) Required standards for approval

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

(3) Standards for approval

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

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

[9] 12 USC § 310

[10] See http://www.federalreserve.gov/releases/iba/current/struca.pdf

(B) the financial and managerial resources of the foreign bank, including the bank's experience and capacity to engage in international banking;
(C) whether the foreign bank has provided the Board with adequate assurances that the bank will make available to the Board such information on the operations or activities of the foreign bank and any affiliate of the bank that the Board deems necessary to determine and enforce compliance with this chapter, the Bank Holding Company Act of 1956 [12 U.S.C. 1841 et seq.], and other applicable Federal law; and
(D) whether the foreign bank and the United States affiliates of the bank are in compliance with applicable United States law.

(4) Factor

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

(5) Establishment of conditions

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

(6) Exception

(A) In general

If the Board is unable to find, under paragraph (2), that a foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country, the Board may nevertheless approve an application by such foreign bank under paragraph (1) if--
(i) the appropriate authorities in the home country of the foreign bank are actively working to establish arrangements for the consolidated supervision of such bank; and (ii) all other factors are consistent with approval.

(B) Other considerations

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

(C) Additional conditions

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

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

(7) Time period for Board action

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

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

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

(e) Termination of foreign bank offices in United States

(1) Standards for termination

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

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

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

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

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

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

(2) Discretion to deny hearing

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

(3) Effective date of termination order

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

(4) Compliance with State and Federal law

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

(6) Enforcement of orders

(A) In general

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

(B) Court order

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

(7) Criteria relating to foreign supervision

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

(f) Judicial review

(1) Jurisdiction of United States courts of appeals

Any foreign bank--

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

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

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

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

located outside the United States and is managed or controlled by such branch or agency, any type of activity that a bank organized under the laws of the United States, any State, or the District of Columbia is not permitted to manage at any branch or subsidiary of such bank which is located outside the United States.

(2) Regulations

Any regulations promulgated to carry out this section--(A) shall be promulgated in accordance with section 3108 of this title; and

(B) shall be uniform, to the extent practicable.

The Federal Reserve's Regulation K deals with foreign operations of US banks and US operations of foreign banks.[11]

COMPREHENSIVE SUPERVISION ON A CONSOLIDATED BASIS

This idea is set out in Basle Principle 24 as a core principle of banking supervision, and is reflected in the US legislation, and in banking legislation in other jurisdictions. Statutes require banks which seek entry into a new jurisdiction to establish that they are subject to consolidated supervision.

Where banks carry out banking operations across borders in complex corporate structures with subsidiaries and branches established in different jurisdictions it may be difficult for any single regulator to know what is going on. In 1983 the Basle Committee agreed on Principles for the Supervision of Banks' Foreign Establishments.[12] In 1992, after the collapse of BCCI in 1991 (see below), the Basle Committee set out Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments.[13] The 1992 standards state that:

Banking groups are increasingly complex organisations and may have several tiers of ownership within them. In some cases, a banking group's home country consolidated supervisory authority will also be the authority directly responsible for the supervision of the group's lead and subsidiary banks. However, in other cases, there will be one authority responsible for the consolidated supervision of the banking group as a whole (the home country authority) and different authorities responsible for the consolidated supervision of individual banks (and such banks' own subsidiaries) that are owned or controlled by the group (the *bank's* home country authority). This may occur, for example, where a banking subsidiary chartered in one country, which is seeking to create an establishment in a second country, is itself

[11] You can access Regulation K at http://www.federalreserve.gov/regulations/ and see below at 26.

[12] http://www.bis.org/publ/bcbsc312.pdf

[13] http://www.bis.org/publ/bcbsc314.pdf

owned by a banking group subject to home country consolidated supervision in a third country. A host country authority must be aware of these distinctions between immediate and higher-level home country authorities. Except where specified, the term home country authority includes both types of authority.

The 1992 standards are as follows:

1. All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision
2. The creation of a cross-border banking establishment should receive the prior consent of both the host country supervisory authority and the bank's and, if different, banking group's home country supervisory authority
3. Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home country supervisor
4. If a host country authority determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments

BCCI (Bank of Credit and Commerce International) SA was closed down by the Bank of England in July 1991 owing at least $10 billion to a large number of depositors around the world. Liquidators have subsequently recovered around 75% of this amount.

BCCI's structure meant that for a long time no regulator was focusing on the group as a whole:

Abu Dhabi Ruling Family

77%

Holding Company(Luxembourg)

BCCI SA
Luxembourg

BCCI OVERSEAS
Cayman Islands

BRANCHES SUBS AGENCIES

BRANCHES SUBS AGENCIES

The following excerpt from a chapter by Albert J. Reiss describes the problems this caused:[14]

To understand what went wrong in regulating BCCI, we must first understand something of its Byzantine structure- a regulatory agency's nightmare of webs joined in an hierarchical network. At the top of the hierarchical pyramid were Abu Dhabi shareholders who created BCCI Holdings, a Luxembourg-registered subsidiary. BCCI Holdings set-up directly held bank subsidiaries in various places, including, for example, Hong Kong, and the United Arab Emirates. It also created a Luxembourg Bank Subsidiary, BCCI Holdings SA, that had a London operating headquarters, subsequently moved to Dhabai, with operations in Britain and a number of other countries, mainly European. A second bank subsidiary, BCCI Overseas, Ltd. was registered in the Cayman Islands. It operated 62 branches in 28 countries, including Pakistan and other Asian and Middle East countries. The bank was clearly organised so that in effect it would be offshore everywhere and consequently hard to regulate. This, perhaps, is the first and most important regulatory lesson to be gleaned from the BCCI debacle: that it is difficult for any country to regulate a corporate holding company that is organised to operate beyond its sovereign domain or that of any other sovereign state.

A lack of an effective multinational insolvency regime means that multinational bank insolvencies are messy. Some jurisdictions, such as the US allow for ring-fencing so that assets located in the US are used for the benefit of depositors in the US. Raj Bhala says, for example:
...state bank regulators were instrumental in making sure that no creditors of BCCI's New York and California agencies lost money. They ensured that BCCI's U.S. operations had positive net worth and successfully "ring-fenced" (or shielded) BCCI's U.S. assets from liquidation proceedings conducted in Luxembourg. Creditors of the U.S. operations were thereby assured of payment in full for their claims.[15]

BCCI's operations involved massive frauds. For example, it was involved in money laundering, had secretly acquired banks including Independence Bank in California, and entered into various simple and complex transactions to disguise losses from bad investments and problem loans to make its financial position look better. Here is a description of some of these transactions from an English case[16]:

1.This application is concerned with six transactions involving the Bank of India ("BOI") and BCCI which took place between 1981 and 1986. In each of five successive years BCCI approached BOI and

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[14] *Detecting, Investigating and Regulating Business Law-Breaking*, in Peter Grabosky and John Braithwaite (eds) BUSINESS REGULATION AND AUSTRALIA'S FUTURE, (1993) at p 192.

[15] Raj Bhala, *Tragedy, Irony, and Protectionism after BCCI: A Three-act Play Starring Maharajah Bank*, 48 SMUL REV 11,36 (1994

[16] *Morris* v *Bank of India* [2004] EWHC 528 (CH)

requested them to enter into an arrangement under which BCCI would deposit monies with BOI for a fixed term, usually of three months. With the assistance of the finance provided by these deposits, BOI would then grant to a company nominated by BCCI a loan for the same period. No formal lien was granted in favour of BOI over the deposits, but BCCI provided a guarantee for the repayment of the principal of the loan and accrued interest. No payments of interest were made on either side during the currency of the deposits and the loans. These arrangements came to be referred to in BOI's internal documentation as BCCI's "usual deal". They were said by those dealing with these matters at the London branch of BOI at the time to be motivated solely by a desire on the part of BCCI to improve what was described as its "earnings to advances ratio" by recording in its accounts a decrease in the amounts outstanding on loan to borrowers and thereby producing a corresponding increase in the amount of interest received relative to the sums lent as at the year end. This practice was on any view highly artificial and was referred to by BOI, both in contemporaneous documents and during the course of the oral evidence, as a form of "window-dressing" by BCCI. It was for this reason that in each of the five years in question the arrangements were timed to coincide with BCCI's year end and the preparation of its balance sheet and accounts, In 1984 (the fourth transaction) there was also a similar transaction which coincided with the period in late September when BCCI's auditors were carrying out their circularisation procedures.
2. The liquidators of Bank of Credit and Commerce International SA ("BCCI SA") and Bank of Credit and Commerce International (Overseas) Limited ("BCCI Overseas"), who are the applicants in these proceedings, allege two things. The first is that each of the transactions was entered into by BCCI SA and BCCI Overseas to assist them and their holding company, BCCI Holdings (Luxembourg) SA ("BCCI Holdings"), to maintain the concealment of serious bad debts and losses incurred by the group on a number of customer accounts and as a result of metal trading carried out for their own account. There is no dispute about this. The conduct of BCCI (by which I refer to the group as a whole) was undoubtedly fraudulent and this is now common ground between the parties to this application. The second allegation is that BOI, by entering into these six transactions under review, knowingly participated in the carrying on of the business of BCCI SA and BCCI Overseas with intent to defraud the creditors of those companies or for a fraudulent purpose. If this allegation (which is denied) is made out, then I have jurisdiction under s.213 of the Insolvency Act 1986 to order BOI to pay compensation to the liquidators for the losses to creditors which have been sustained.

BCCI’s liquidators also sued the Bank of England, claiming that it was liable because of misfeasance in public office. In 2001 the House of Lords refused to strike out a claim that the Bank of England should be liable in relation to its regulation of BCCI.[17] This excerpt from Lord Hope of Craighead’s decision describes the BCCI situation:

16. The history of the rise and fall of the Bank of Credit and Commerce International SA ("BCCI SA") can conveniently be divided up for the purposes of this action into four periods: (1) the period prior to the

[17] *Three Rivers District Council* v *Bank of England* [2001] UKHL 16.

grant of a full licence under the Banking Act 1979 on 19 June 1980; (2) the period from the grant of the full licence to December 1986; (3) the period from December 1986 to April 1990; and (4) the period from April 1990 to closure in July 1991.... What follows is not intended to be a complete or definitive account of what happened. But for the purposes of this judgment it is necessary to provide an outline of the chronology and to identify some of the more important details in that history.

17. BCCI SA was incorporated under the laws of Luxembourg on 21 September 1972. In November it established its first office in the United Kingdom and commenced its business in this country as a deposit-taker. Two years later the structure of BCCI was altered by the incorporation on 13 December 1974 of BCCI Holdings SA ("Holdings") in Luxembourg of which BCCI SA became a subsidiary. On 25 November 1975 another subsidiary of Holdings called BCCI Overseas ("Overseas") was incorporated in the Cayman Islands. Overseas opened its first branch in the United Kingdom in June 1976. At this stage a substantial part of the issued share capital of Holdings was owned by the Bank of America. Although the group was trading through various branches in the United Kingdom it was not subject to any regulatory system in this country. But Holdings was subject to regulation in Luxembourg by the Luxembourg Banking Commission ("LBC") which at that time was that country's regulatory authority. At the end of 1977 the Bank of America decided to withdraw from its relationship with BCCI. It sold its holding of shares in Holdings to International Credit and Investment Co Ltd ("ICIC") which at that time was BCCI's largest shareholder.

18. Prior to the enactment of the Banking Act 1979 banking in the United Kingdom was not subject to any formalised system of regulation. Control was exercised in an informal way by the Bank of England and in an indirect manner by means of various statutory provisions which gave privileges to banks which were recognised by the Board of Trade and by the Bank. Following the publication of a White Paper in 1976 and the First Council Banking Co-ordination Directive (77/780/EEC) steps were taken to establish a new statutory system of banking supervision in the United Kingdom. This was contained in the Banking Act 1979, which came into force on 1 October 1979. It provided for the recognition of banks under section 3(1) if they satisfied the criteria in Schedule 2, Part I, and for the licensing of deposit-taking institutions under section 3(2) if they satisfied the less stringent criteria in Schedule 2, Part II. Section 3(5) of the Act provided that, in the case of an institution whose principal place of business was in a country or territory outside the United Kingdom, the Bank might regard itself as satisfied that the criteria in Schedule 2 regarding those responsible for the management of the business and the prudence with which its business was being conducted were fulfilled if the relevant supervisory authorities informed the Bank that they were satisfied with respect to them and the Bank was satisfied as to the nature and scope of the supervision exercised by those authorities.

19. On 1 October 1979 BCCI SA applied to the Bank for recognition as a bank under the Act. On 19 June 1980 the Bank refused recognition as a bank but granted to BCCI SA a full licence under the Act as a deposit-taker. By that date its principal place of business was in the United Kingdom. Nevertheless the Bank decided to rely under section 3(5) of the 1979 Act on the supervision of its activities by LBC. The claimants' case is that when the Bank granted the licence (a) it did so knowingly deliberately contrary to the statutory scheme or (b) it was recklessly indifferent to whether it was acting in accordance with the scheme or (c) it wilfully disregarded the risk that it was not acting in accordance

with that scheme (i) in bad faith and (ii)(a) in the knowledge that the likely consequences were losses to depositors and potential depositors or (b) that it wilfully disregarded the risk of the consequences or (c) that it was recklessly indifferent to those consequences: see paragraph 31 of the new draft particulars.

20. During the period from June 1980 to December 1986 the activities of the BCCI group expanded dramatically not only in the United Kingdom but throughout the world. Officials of the Bank pointed out that it was unsatisfactory for it as the supervising authority of BCCI SA in the United Kingdom to rely, as it had been doing under section 3(5) of the 1979 Act, on the views of LBC as to the activities of the holding company in Luxembourg. They recognised that, as the activities of BCCI continued to expand, pressure was likely to grow for its recognition as a bank under that Act. Various possible solutions were considered including, on the one hand, a proposal for the Bank to supervise the whole institution and, on the other, the incorporation of Holdings in the United Kingdom to improve the effectiveness of the Bank's supervision of the group's activities in this country. In September 1984 the effectiveness of the existing statutory regime was called into question by the collapse of Johnson Matthey Bankers. In the light of that debacle a further White Paper was produced and the enactment of a new statute, which was to become the Banking Act 1987, was proposed. The system introduced by the 1979 Act was to be both strengthened and simplified. In place of the dual system of recognition and licensing a single system of authorisation was to be introduced with restrictions on the use of banking names. The Bank was to be required to establish a committee to be known as the Board of Banking Supervision which was to include six independent members as well as three members ex officio. Various other changes were to be made to the powers and duties of the Bank as regulatory authority.

21. Meantime the Bank continued to rely on the views of the Luxembourg regulatory authority. In May 1983 the responsibilities of regulatory authority in that country had passed from the LBC to L'Institute Monetaire Luxembourgeois ("IML"). Further memoranda passed between officials of the Bank drawing attention yet again to the fact that the real place of business of the BCCI SA was in London and that effectively the Bank and not IML was its prime supervisor. Concern was expressed about heavy losses resulting from BCCI SA's central treasury activities which had been identified by BCCI SA's auditors but not been reported to the Bank and BCCI's lack of candour about its decision to relocate its central treasury operation from London to Abu Dhabi.

22. The claimants' case regarding this period, which follows the same pattern as that set out in paragraph 31 of the new draft particulars which relates to the first period, is that the Bank was continuing to rely on assurances from LBC and IML and, that despite its knowledge of the illegality of this arrangement and the likelihood of losses to depositors, it failed in bad faith to take steps to revoke BCCI SA's licence under section 7 of the 1979 Act.

23. The next period was marked by a number of changes in the supervisory regime and further expressions of concern about the activities of BCCI. The 1987 Act came into force on 1 October 1987. Section 3(5) of the 1979 Act was replaced by an equivalent provision in section 9(3) of the 1987 Act. BCCI SA was deemed to be authorised under the 1987 Act by section 107 of that Act and Schedule 5, paragraph 2. An international co-operative group, known as "the College", was established to enable the various national supervisors of the operations of the BCCI Group to meet twice-yearly to discuss its financial condition. Concern was expressed at meetings of the College about a large concentration of

exposures due to the group's lending and the effect on the group's activities of the arrest of seven of its officials in Tampa, Florida in October 1988 on charges of drug-trafficking, money-laundering and conspiracy. Further consideration was given to proposals for the restructuring of the group's activities with a view to achieving effective consolidated supervision in London by the Bank. On 30 January 1990 the Bank decided to continue BCCI SA's authorisation following a decision of the Tampa prosecutor to enter into a plea-bargain agreement, approved by the court, by which SA and Overseas pleaded guilty to all counts of money-laundering and conspiracy. Concerns were expressed to the Bank by the group's auditors, Price Waterhouse ("PW"), about the probity of BCCI's senior management.

24. The claimants' case regarding this period contains three specific allegations about decisions by the Bank not to withdraw the authorisation from BCCI SA. These are said to have been taken (1) after the Bank had learned in May 1986 that BCCI, which had been dealing on a massive scale in the financial and commodity markets through its central treasury in London, had incurred losses amounting to some $285 million... (2) after a paper prepared by the Bank for the Board of Banking Supervision in November 1989 had revealed serious defects in the group's structure and the existing supervisory regime and the extent to which BCCI's activities in the UK were dependent upon what happened elsewhere in the group which was largely unsupervised... and (3) after the officials of BCCI had pleaded guilty in Tampa, Florida in January 1990 to charges of money-laundering and conspiracy....

25. The final period from April 1990 to closure in July 1991 began with expressions of concern to the Bank by PW about the group's serious financial problems and reports about efforts which were being made to obtain financial support from the majority shareholders. On 18 April 1990 PW reported to the board of Holdings that they were unable to sign the 1989 accounts. Later that month they felt able to do so in the light of expressions of support for the group by the Abu Dhabi Government. In early June 1990 IML, recognising that they were no longer in a position effectively to supervise their activities, gave notice to Holdings and to BCCI SA that they must leave Luxembourg within the next 12 to 15 months. These matters were discussed at a meeting of the College on 19 June 1990 when IML repeated its ultimatum and the Cayman supervisor said that, if SA had to leave Luxembourg, Overseas would have to leave Cayman. Further consideration was given to the need for a clear group structure, consolidated supervision of its activities, relocation of the group to Abu Dhabi and the need for a clear and substantial commitment by the Abu Dhabi Government of its support for it.

26. In October 1990 PW reported to Holdings' audit committee that an urgent investigation was needed to quantify the group's liabilities and its need for financial support. On 5 October 1990 a letter was produced to the College on behalf of the majority shareholders undertaking to provide support to the level indicated by PW. But IML refused to extend its deadline unless certain conditions were met and the supervisors did not regard the shareholders' proposals for support as acceptable. By December 1990 a revised support package had been put together which PW regarded as acceptable, but later that month PW became aware of the extent to which BCCI's financial problems were due to fraudulent activities on the part of management. On 4 March 1991 the Bank commissioned PW to investigate and report to it under section 41 of the Banking Act 1987 on malpractice within BCCI. PW delivered their report to the Bank on 24 June 1991. It contained a comprehensive account of widespread frauds and deceptions which had been perpetrated by BCCI. Four days later the Bank decided that the proposed reconstruction

of the group could not be pursued and that to protect depositors BCCI SA had to be closed down. On 5 July 1991 the Bank presented a petition for the appointment of a provisional liquidator.
27. The claimants' case regarding this period, as explained by Lord Neill QC in oral argument, is based on general allegations that the Bank failed in bad faith to face up to its responsibilities as a supervisor to take decisions that would protect the interests of depositors and potential depositors when it was aware that there was a serious and immediate threat that unless it was rescued by the Abu Dhabi Government BCCI would collapse.

..The Bingham Report
28. The closure of BCCI on 5 July 1991 provoked widespread concern in the financial community on the ground that this action was long overdue, yet the action that was taken was criticised by depositors, employees and shareholders as precipitate. In a prompt response to that concern Bingham LJ was invited to conduct an inquiry into the supervision of BCCI under the Banking Acts, to consider whether the action taken by all the UK authorities was timely and to make recommendations. The establishment of the inquiry was announced on 19 July 1991. Bingham LJ submitted his report to the Chancellor of the Exchequer and the Governor of the Bank in July 1992. Among the questions which he understood to call for consideration by his terms of reference were the following: What did the UK authorities know about BCCI at the relevant times? Should they have known more? And should they have acted differently?
29. The report (Inquiry into the Supervision of the Bank of Credit and Commerce International (HC Paper (1992-93) No 198) contains a masterly and eminently readable account of the entire sequence of events from the establishment of BCCI in the UK in 1972 to its closure in July 1991. Bingham LJ took evidence both orally and in writing from a large number of witnesses and he had access to many documents. In his covering letter he paid tribute to the very high level of co-operation which he had received from, among others, the Bank and the UK firm of Price Waterhouse, who acted from June 1987 to July 1991 as the group's auditors. He said that in deciding what was said and done during BCCI's nineteen year history he had relied heavily on contemporary notes and minutes of meetings and conversations between the Bank and Price Waterhouse. His report contains numerous findings of fact and expression of opinion relevant to the questions which he understood to have been comprised within his terms of reference. The report was published in October 1992, but eight appendices to the report were not published.
30. Much of the claimants' pleading has been based upon material taken from that report. This is unsurprising, in view of the fact that the claimants have not yet had the benefit of discovery of documents or the obtaining of answers to interrogatories. The assumption can properly be made at this stage that the narrative which the report contains will in due course be capable of being established by evidence once the claimants have obtained access to the relevant documents. But there are important limitations on the use which can be made of this document. I shall have to deal with this matter in more detail later when I come to the arguments relating to strike out, but I should like to make the following observations at this stage.
31. The first point that has to be borne in mind is that neither the report itself nor any of its findings or conclusions will be admissible at any trial in this case. At this stage, when the only material that is

available for consideration apart from the pleadings is the report and an incomplete bundle of relevant documents, it is tempting to fill in the gaps by reference to Bingham LJ's findings and the conclusions which he was able to draw from his review of the evidence. Nevertheless a sharp dividing line must be observed between, on the one hand, his narrative of the evidence and, on the other hand, his findings and conclusions in the light of that evidence.

32. It can, as I have said, be assumed that if the claim is not struck out the claimants will in due course have access to the evidence which provides the source material for that narrative, and that that evidence will be capable of being led by them at the trial. But, as Bingham LJ's findings and conclusions based on that narrative are inadmissible, they must be held to be incapable either of being led in evidence at the trial or of being used by either side in any other way in support of the competing arguments. As Hirst LJ observed in the Court of Appeal, no comparable statutory provisions to those which are to be found in section 441 of the Companies Act 1985 apply to the Bingham report: [2000] 2 WLR 15, 91A-C. The investigation which Bingham LJ conducted was a private and not a statutory inquiry. The rigorous attention which must be paid to the distinction between what would and what would not be admissible has not always been observed in the written cases, and I had the impression that it was not always being observed during the oral argument. Nor, for reasons which I shall explain later, do I think that it was always observed either by Clarke J or by the majority in the Court of Appeal in their judgments on the issues relating to the question of strike out. This has an important bearing on the question whether those judgments were soundly based and should be upheld or whether, because they were not soundly based, the question of strike out is now at large for your Lordships' re-consideration.

33. A further point that should be noted at this stage about the findings and conclusions in the Bingham report is that they were the result of an investigation that lacked the benefit of statutory powers and was conducted behind closed doors. The claimants were not present nor were they represented. In the conduct of his fact-finding exercise Bingham LJ was, as he said in his covering letter, greatly assisted by the co-operation which he received especially from the Bank and Price Waterhouse. But he had no power to compel the attendance of witnesses or to require the production of documents, and there was no counsel to the inquiry. As the appendices have not been published, the claimants have not had access to all the material which Bingham LJ had before him. None of these observations are intended to suggest that the investigation was incomplete or that the report, for the purposes for which it was prepared, is in any way open to criticism. But it is plain that it cannot be suggested that Bingham LJ was in a position to conduct a fair trial of the issues relating to the tort of misfeasance in public office which the claimants are seeking to raise against the Bank in this case. In these circumstances I agree with the views which Auld LJ expressed in the Court of Appeal in his minority judgment when he said that it would not be right to treat the Bingham report as effectively conclusive on the questions that arise in this litigation or to conclude that all the available evidence on those questions has been gathered in: [2000] 2 WLR 15 180 D-E.

Ultimately this case went to trial, but the liquidators abandoned the case on the 256th day of trial. The following excerpt is from a decision in **Three Rivers District Council v Bank of**

England on the costs in the litigation:[18]

10. I have probably already said enough to indicate that this was extraordinary litigation which came to an abrupt albeit long overdue conclusion in unusual circumstances. What appears to have occurred, although I was not told, is that on 23 September 2005 the English Liquidation Committee of BCCI, representing its biggest creditors, passed 'a strongly worded resolution calling on Deloittes (the liquidators) to discontinue [the action] forthwith' - see a report in The Times Newspaper of 4 November 2005. The liquidators evidently did not comply with that resolution but instead applied to the Chancellor of the High Court, Sir Andrew Morritt, for directions. Mr Pollock told me that the Chancellor heard argument over a period of three days but he was unable to tell me or at any rate did not tell me whether the argument was adversarial and what position was adopted by whom. The fact that the Chancellor concluded that it was no longer in the best interests of the creditors for the litigation to continue and that he directed that it be discontinued speaks for itself. The Chancellor must have concluded that the liquidators had no worthwhile prospect of success. He would have been unlikely lightly to have condemned the liquidators to the payment of the substantial costs involved in a 256 day trial, an order to which effect would inevitably follow discontinuance.

11 The liquidators did not withdraw their allegations nor proffer any apology. They can be compelled to do neither and they may not wish to do so. However the position in which the Bank and the impugned officials are left is unsatisfactory, as is likewise the position of the families of those impugned officials who are now dead. It is made worse by the fact that for their own purposes the liquidators have assiduously courted publicity in respect of their claim against the Bank. A public relations consultancy was retained by the liquidators to assist them in this regard. Helping the media 'grasp the complexities' of 'inter alia, ongoing litigation against the Bank' is described by that consultancy as one of the principal corporate projects on which it worked in 2003. As part of a campaign of this sort I have no doubt that the urge to make available to the Press selective extracts from documents was irresistible, as they could be deployed in a manner which apparently showed the Bank in a bad light. I make no criticism of those who published such extracts as they were given. As an exercise in objectivity however, this can be seen with the hindsight acquired from experience of the trial as a cynical and grotesque operation. Many of the documents which were deployed in this way formed part of an arcane debate on one or more obscure and highly technical topics concerning banking supervision. The documents and the annotations thereon by Bank officials could not properly be understood without careful study of the surrounding and associated material in order to immerse oneself in the debate to which they related, by definition a debate which took place a very long time ago. A wholly distorted picture of the Bank's conduct was thereby painted.

12 Moreover, the publicity courted by the liquidators included a number of public statements by them or on their behalf made before and during the trial which appeared to be intended to portray the Bank as being unreasonable in failing to negotiate a commercial settlement of the litigation. On the final day of the trial, following their discontinuance, the liquidators issued a Press Release which can only be

[18] [2006] EWHC 816 (Comm).

described as lamentable. It was well summarised by Jeremy Warner, writing in The Independent newspaper on 3 November 2005: -

'Unrepentant to the last, they [the liquidators] yesterday cynically blamed both the length and costs of the case on the supposed unreasonableness of the Bank, and tried to make out that the Bank's refusal to negotiate a commercial settlement was in some way a dishonourable approach to the matter. Dear oh dear.'

One passage in that Press Release read as follows: -

'The Bank has invested a very substantial amount of money in its defence and this has increased the costs required to be spent by the Liquidators. The Bank's own costs have been running at approximately double the level of the Liquidators' costs. The case has continued far longer than anticipated, with far greater costs than expected, and it could continue for several years to come. The Bank has made it very clear that normal commercial considerations do not apply to this issue and it will not negotiate.'

In the Notes for Editors there appeared the following passage: -

'The Liquidators have previously made a number of abortive attempts to negotiate a settlement. The Bank's position was that it would not negotiate any form of compromise.'

The inference which I derive from this document is that the liquidators pursued the claim for the length of time which they did in the belief, expectation or hope that the Bank would ultimately agree some form of compromise settlement in order to avoid the criticisms and embarrassment to which it would be exposed in a public trial. The public relations campaign was obviously designed to put pressure on the Bank to capitulate in that fashion.

The Judge was critical of the liquidator's numerous casual and unsubstantiated allegations that officials at the Bank of England had acted dishonestly in their regulation of BCCI and awarded costs to the Bank on an indemnity costs basis,[19] but he said:

[136] I should also make it plain that it should not be thought that as a result of my consideration of the evidence in this case I have concluded that the Bank is beyond criticism of the manner in which it discharged such duties as were cast upon it in consequence of its permitting BCCI SA to carry on business within the UK. It was not however my task to identify matters in respect of which the Bank could be criticised. It was not for me to identify areas where the Bank might arguably have been complacent or in respect of which it may have made errors of judgment or been negligent. That was the task of Bingham LJ and he expressed various criticisms of the Bank in his report. It was my task to determine whether the Bank had as alleged by the liquidators approached its duties in a manner which

[19] In paragraph 14 of the judgment the Judge described this costs basis as follows: "The significance of costs being ordered to be paid on an indemnity as opposed to the standard basis is that, although the beneficiary of such an order will still only be paid costs which have been reasonably incurred, there is no requirement of proportionality and in cases of doubt on assessment it is for the payer to show that the costs were not reasonably incurred. Whilst an indemnity costs order does carry at least some stigma the purpose of such an order is not to punish the paying party but to give a more fair result for the party in whose favour a costs order is made."

amounted to the tort of misfeasance in public office. This is a very different inquiry. The liquidators alleged that the Bank by 22 of its officials had acted deliberately unlawfully and in bad faith and that at least 42 of its officials had employed widespread dishonesty in order to ensure that this conduct could take place and that it would go undetected. In this judgment I have sought briefly to explain why in my view the Bank's officials should be exonerated of the grave allegations made against them.

Different countries now address the risks associated with multinational banking operations in their rules for approval of foreign banks. Here is a description of how the UK has addressed these issues:[20]

Home Country Supervisor assessments
17.... we carry out our own assessments of home country supervisors against the internationally accepted standards set out by the Basel Committee for Banking Supervision in its 'Core Principles'. If our assessments identify shortfalls in an overseas jurisdiction's supervision, we then consider if we are able to fill the gaps, and thereby meet our regulatory objectives, through other means.
18. Previous experience has shown that stated compliance with the Basel Core Principles does not mean that countries are in fact complying. This was particularly evident during the Asian financial crisis and was one of the main reasons for the establishment of the IMF's Financial Sector Assessment Programme. We regard the IMF's work in this area as very important and fully support it, not least by offering our own staff to assist with the assessments of overseas supervisory regimes. At present, the boot is somewhat on the other foot as it is our supervision that is currently the subject of an IMF assessment!
19. In cases where our assessment finds that home country supervisors comply with the Basel Core Principles, either in whole or in substantial part, we then proceed to consider whether the bank meets the Threshold Conditions for authorisation more generally. These conditions include the adequacy of financial resources, management and systems and controls. In making this assessment we will not, as a general rule, seek to duplicate work done by the home country supervisor. Again this is more efficient for all concerned.

Our policy for Home Country Supervisors which fall short of international standards
20. However, our assessment may find that we can place little or no reliance on the home country supervisor. What do we do in such circumstances?
21. It is clear that we need a consistent approach to help us ensure that all non-EEA banks with a branch in the UK are meeting the Threshold Conditions. This is important in its own right and also because Article 24 of the EU's Banking Consolidation Directive requires us not to treat non-EEA banks more favourably than banks from the EEA. As a consequence, we have not for some time accepted branch applications from banks in countries where we cannot rely on the work of the home country

[20] From a speech by David Strachan of the FSA on Regulation and Liberalisation, Apr. 24, 2002, available at http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2002/sp97.shtml.

supervisor.
22. However, this approach should not deter applications for UK-incorporated entities by banks from countries where we cannot rely on the home supervisor. Another option available to all banks, including non-EEA banks since the new Act came into force, but not taken advantage of thus far, is to apply for a wholesale-only deposit taking permission. As the name suggests, this new category of deposit taker is limited to taking deposits from wholesale customers only. Because such banks will not be able to take deposits from retail customers, they pose - by definition - less risk to our consumer protection objective. This route may provide a means for banks from non-EEA countries where the gaps in regulation, though significant are not unmanageably large, to open branches here.
23. Thus we have a very clear and consistent approach for dealing with new applications by banks from such countries to open UK branches. However, we have also had to deal with the legacy of a number of banks which established operations here many years ago, in some cases well before the first Banking Act was introduced in 1979. The approach that we have adopted in these cases has been risk-based. It would have been neither necessary nor proportionate to require all banks from countries whose supervisors did not meet the Basel Core Principles in their entirety to close or restructure immediately. In many cases it may well have not been in the interests of depositors here to require such steps.
24. Instead, the approach we took was to identify those branches which posed the greatest risk to consumers, put in place appropriate measures to protect consumers' interests and seek the restructuring or withdrawal of those branches through discussion with the banks' senior management and home supervisors.
25. Thus far, this approach has led to the departure of around a dozen non-EEA branches, through a combination of voluntary withdrawals and the subsidiarisation of some banks' UK operations.

Reductions in the number of non-EEA branches in the UK
26. On the face of it, there is an argument to the effect that this approach is limiting access to UK markets and hence competition in the UK. I find this a very superficial argument. It is certainly not borne out by the overall numbers. Instead what we have done is to allow open access to the UK's financial markets provided such access does not threaten our ability to discharge our regulatory objectives. That has allowed competition to thrive in a way that benefits consumers.
27. What do the numbers look like? In total, 43 non-EEA branches have left the UK over the last five years and the net reduction was 31 banks (or 21% of the total number). The main reasons for withdrawals during the period were commercial ones, eg the retrenchment of the Japanese banks and other banks from the Far East. There were other withdrawals where emerging markets banks were purchased by a larger bank with an already sizeable UK presence. In addition, several non-EEA banks turned their UK branches into subsidiaries incorporated here.
28. And when you compare the reduction in non-EEA branch numbers with other European countries, you will see that we have not been out of step. According to figures published by the European Commission, there was a 20% decrease in the number of non-EEA branches between July 1998 and December 2001, most notably in France, Germany and Spain. The decreases appear to be for reasons broadly similar to those we have seen in the UK.

29. Thus the figures for the UK and the rest of the EU are broadly comparable. They certainly do not suggest that we are being overly restrictive in our approach.

More recently the Chairman of the FSA, Callum McCarthy, said:[21]

4....First, there is the need for us in the FSA as the regulatory organisation in London to have a counterparty in the overseas institution here in London with whom we can do business. You know that one of the guiding principles of the FSA is that we look to the senior management of those whom we regulate to take responsibility for their irms. It is their responsibility to act prudently and honestly, to set up and maintain controls which work, and to manage the risks which are inescapable in financial institutions. This responsibility must lie with the senior management of the company in the first instance: it is not something which principally lies with compliance functions or with internal audit – though, of course, both these can and should play useful supporting roles. So we need, for each financial institution operating in London, a clear means of communicating with the firm's senior management – which, in turn, means that we need the firm's London management to have the necessary clout within the firm. In a world of matrix management, where global product heads coexist with those with geographical responsibilities, this clout is not self-evident. So you must expect us to be interested in you, in London, having a clear and respected voice back to Tokyo, or New York, or Frankfurt, or any other head office. Second, there are clearly regulatory issues which arise from all cross-border banking, and which revolve round the correct relationship between home and host regulator. This general problem comes in many guises. For large groups operating substantially in London and New York and other capital market centres there is a need for full consultation and exchange of views between the regulatory authorities in the countries – something which I think works well between the major regulatory organisations. The FSA talks repeatedly with the New York Fed, and the Japanese FSA; for major groups like UBS or Credit Suisse based in Switzerland we hold tripartite meetings of American, British and Swiss Banking authorities. In other instances, we can find an imbalance between the expertise of a small home country regulator on the one hand, and the different issues which arise in a much larger and more sophisticated market such as the London market on the other. Here again, I think that these problems have been dealt with quite successfully, with the fallback position of reverting to a subsidiary rather than a branch status used where necessary. But both instances represent complications on the regulatory template.
Third, there are regulatory complexities which come from different national systems of regulation: notably the difference between those countries like the UK, Germany or Japan in which regulation of (almost) all financial services falls under one regulator, and those countries where the responsibility is divided between several or even many regulators. For certain firms there has historically been no means of establishing a group view as well as a view of individual entities - something which the EU requirement for consolidated supervision will change. Last, there are some particular regulatory issues which arise for exchanges, where we need to make sure that different countries' requirements are

[21] Callum McCarthy, London as an International Capital Market, (Mar. 17, 2004) *available at* http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2004/SP169.shtml.

properly identified and dealt with.
5 I list these various types of international regulatory complexity not to claim that they are insoluble – indeed, experience shows that with hard work and goodwill they are soluble, and indeed have been solved. Nor do I list them as an excuse for protectionism: one of the dangers against which we should guard is the argument that regulation requires national solutions, or national ownership or management. As I said, the UK has greatly benefited from having an open policy towards foreign financial services companies. It is important that we retain this policy. But we will do best if we recognise that there are special features which require additional work, and put in the additional effort.
6 With that background, let me turn to the wider issues of what we expect of international banks, and what they should expect of the FSA. You should expect us to work hard to promote wholesale markets which are efficient, orderly and clean. That is an objective which no-one argues against as a principle: it is necessary if London is to remain a competitive capital market centre that we should be efficient; it is in everybody's interests that markets are not disorderly; and it is clearly right that markets should be clean – that there is a set of rules, observed in practice as well as set out in rule books, which establish fair behaviour and prevent improper preference being given to one category of market participant or market user over others. The objective, as I say, is unexceptionable. What is more debatable is the cost of achieving this objective: how much effort, how much cost, is justified in any particular case? And how does the cumulative cost of individual measures affect efficiency and competitiveness? These are questions which we at the FSA live with all the time. This is as you would expect from an organisation which has a statutory duty, the requirement to act proportionately and efficiently, and which subjects all its proposals to cost benefit analysis. And – even were we not committed ourselves by law and by conviction to this principle – I am confident that the practitioners who pay the FSA's costs, and other commentators too, would make sure that this principle was repeatedly brought to our attention.
7 I am therefore concerned to look hard at how we measure up against this test. I think the evidence is reasonably reassuring. I am heartened by the evidence of those who vote with their investment decisions, namely the international banks and international financial services companies represented here tonight. You are among the most internationally mobile of businesses, not only able to switch markets as more competitive market places – real or virtual – develop , but with a track record of demonstrating that you translate that capability into action.
I take further encouragement from the results of a survey carried out last year by the Centre for the Study of Financial Innovation on behalf of the City Corporation. They asked 350 institutions – more than half of them under non-British ownership – for their views on the relative attractions of London, New York, Frankfurt and Paris as major international centres. Overall, London came a close second to New York in terms of international financial centre competitiveness. When asked to compare the different regulatory environments in the four centres, respondents put London on top of the list by a big margin. My own conversations with international bankers make clear to me that the threat to London as a major capital market centre arises more from the state of our transport systems than it does from the state of regulation. London also did well going forward; it was expected to have the most positive regulatory environment in five years' time, from the point of view of running a financial services business...

Clearly here there is a concern about whether strict regulation of foreign institutions is protectionist. After BCCI the US enacted the Foreign Bank Supervision Enhancement Act of 1991 which one commentator has suggested is a protectionist measure.[22] **Regulation K** under this Act now addresses these issues about the regulation of foreign banks with the following provisions (in 12 CFR 211):

§ 211.2 Definitions.
Unless otherwise specified, for purposes of this subpart:...
(j) **Foreign bank** means an organization that:
(1) Is organized under the laws of a foreign country;
(2) Engages in the business of banking;
(3) Is recognized as a bank by the bank supervisory or monetary authority of the country of its organization or principal banking operations;
(4) Receives deposits to a substantial extent in the regular course of its business; and
(5) Has the power to accept demand deposits.
(k) **Foreign branch** means an office of an organization (other than a representative office) that is located outside the country in which the organization is legally established and at which a banking or financing business is conducted...
(v) **Representative office** means an office that:
(1) Engages solely in representational and administrative functions (such as soliciting new business or acting as liaison between the organization's head office and customers in the United States); and
(2) Does not have authority to make any business decision (other than decisions relating to its premises or personnel) for the account of the organization it represents, including contracting for any deposit or deposit-like liability on behalf of the organization.
(w) **Subsidiary** means an organization that has more than 50 percent of its voting shares held directly or indirectly, or that otherwise is controlled or capable of being controlled, by the investor or an affiliate of the investor under any authority. Among other circumstances, an investor is considered to control an organization if:
(1) The investor or an affiliate is a general partner of the organization; or
(2) The investor and its affiliates directly or indirectly own or control more than 50 percent of the equity of the organization...

§ 211.24 Approval of offices of foreign banks; procedures for applications; standards for approval; representative office activities and standards for approval; preservation of existing authority.
(a) Board approval of offices of foreign banks—(1) Prior Board approval of branches, agencies,

[22] *See*, *e.g.*, Raj Bhala, *Tragedy, Irony, and Protectionism after BCCI: A Three-act Play Starring Maharajah Bank*, 48 SMUL REV 11 (1994) (arguing that the statute is protectionist).

commercial lending companies, or representative offices of foreign banks. (i) Except as otherwise provided in paragraphs (a)(2) and (a)(3) of this section, a foreign bank shall obtain the approval of the Board before it:
(A) Establishes a branch, agency, commercial lending company subsidiary, or representative office in the United States; or
(B) Acquires ownership or control of a commercial lending company subsidiary.
(2) Prior notice for certain offices. (i) After providing 45 days' prior written notice to the Board, a foreign bank may establish:
(A) An additional office (other than a domestic branch outside the home state of the foreign bank established pursuant to section 5(a)(3) of the IBA (12 U.S.C. 3103(a)(3))), provided that the Board has previously determined the foreign bank to be subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor (comprehensive consolidated supervision or CCS); or
(B) A representative office, if:
(1) The Board has not yet determined the foreign bank to be subject to consolidated comprehensive supervision, but the foreign bank is subject to the BHC Act, either directly or through section 8(a) of the IBA (12 U.S.C. 3106(a)); or
(2) The Board previously has approved an application by the foreign bank to establish a branch or agency pursuant to the standard set forth in paragraph (c)(1)(iii) of this section; or
(3) The Board previously has approved an application by the foreign bank to establish a representative office.
(ii) The Board may waive the 45-day notice period if it finds that immediate action is required by the circumstances presented. The notice period shall commence at the time the notice is received by the appropriate Federal Reserve Bank. The Board may suspend the period or require Board approval prior to the establishment of such office if the notification raises significant policy or supervisory concerns.
(3) General consent for certain representative offices. (i) The Board grants its general consent for a foreign bank that is subject to the BHC Act, either directly or through section 8(a) of the IBA (12 U.S.C. 3106(a)), to establish:
(A) A representative office, but only if the Board has previously determined that the foreign bank proposing to establish a representative office is subject to consolidated comprehensive supervision;
(B) A regional administrative office; or
(C) An office that solely engages in limited administrative functions (such as separately maintaining back-office support systems) that:
(1) Are clearly defined;
(2) Are performed in connection with the U.S. banking activities of the foreign bank; and
(3) Do not involve contact or liaison with customers or potential customers, beyond incidental contact with existing customers relating to administrative matters (such as verification or correction of account information).
(4) Suspension of general consent or prior notice procedures. The Board may, at any time, upon notice, modify or suspend the prior notice and general consent procedures in paragraphs (a)(2) and (3) of this section for any foreign bank with respect to the establishment by such foreign bank of any U.S. office of

such foreign bank.
(5) Temporary offices. The Board may, in its discretion, determine that a foreign bank has not established an office if the foreign bank temporarily operates at one or more additional locations in the same city of an existing branch or agency due to renovations, an expansion of activities, a merger or consolidation of the operations of affiliated foreign banks or companies, or other similar circumstances. The foreign bank must provide reasonable advance notice of its intent temporarily to utilize additional locations, and the Board may impose such conditions in connection with its determination as it deems necessary.
(6) After-the-fact Board approval. Where a foreign bank proposes to establish an office in the United States through the acquisition of, or merger or consolidation with, another foreign bank with an office in the United States, the Board may, in its discretion, allow the acquisition, merger, or consolidation to proceed before an application to establish the office has been filed or acted upon under this section if:
(i) The foreign bank or banks resulting from the acquisition, merger, or consolidation, will not directly or indirectly own or control more than 5 percent of any class of the voting securities of, or control, a U.S. bank;
(ii) The Board is given reasonable advance notice of the proposed acquisition, merger, or consolidation; and
(iii) Prior to consummation of the acquisition, merger, or consolidation, each foreign bank, as appropriate, commits in writing either:
(A) To comply with the procedures for an application under this section within a reasonable period of time; to engage in no new lines of business, or otherwise to expand its U.S. activities until the disposition of the application; and to abide by the Board's decision on the application, including, if necessary, a decision to terminate the activities of any such U.S. office, as the Board or the Comptroller may require; or
(B) Promptly to wind-down and close any office, the establishment of which would have required an application under this section; and to engage in no new lines of business or otherwise to expand its U.S. activities prior to the closure of such office.
(7) Notice of change in ownership or control or conversion of existing office or establishment of representative office under general-consent authority. A foreign bank with a U.S. office shall notify the Board in writing within 10 days of the occurrence of any of the following events:
(i) A change in the foreign bank's ownership or control, where the foreign bank is acquired or controlled by another foreign bank or company and the acquired foreign bank with a U.S. office continues to operate in the same corporate form as prior to the change in ownership or control;
(ii) The conversion of a branch to an agency or representative office; an agency to a representative office; or a branch or agency from a federal to a state license, or a state to a federal license; or
(iii) The establishment of a representative office under general-consent authority.
(8) Transactions subject to approval under Regulation Y. Subpart B of Regulation Y (12 CFR 225.11–225.17) governs the acquisition by a foreign banking organization of direct or indirect ownership or control of any voting securities of a bank or bank holding company in the United States if the acquisition results in the foreign banking organization's ownership or control of more than 5 percent of

any class of voting securities of a U.S. bank or bank holding company, including through acquisition of a foreign bank or foreign banking organization that owns or controls more than 5 percent of any class of the voting securities of a U.S. bank or bank holding company.

(b) Procedures for application—(1) Filing application. An application for the Board's approval pursuant to this section shall be filed in the manner prescribed by the Board.

(2) Publication requirement—(i) Newspaper notice. Except with respect to a proposed transaction where more extensive notice is required by statute or as otherwise provided in paragraphs (b)(2)(ii) and (iii) of this section, an applicant under this section shall publish a notice in a newspaper of general circulation in the community in which the applicant proposes to engage in business.

(ii) Contents of notice. The newspaper notice shall:

(A) State that an application is being filed as of the date of the newspaper notice; and

(B) Provide the name of the applicant, the subject matter of the application, the place where comments should be sent, and the date by which comments are due, pursuant to paragraph (b)(3) of this section.

(iii) Copy of notice with application. The applicant shall furnish with its application to the Board a copy of the newspaper notice, the date of its publication, and the name and address of the newspaper in which it was published.

(iv) Exception. The Board may modify the publication requirement of paragraphs (b)(2)(i) and (ii) of this section in appropriate circumstances.

(v) Federal branch or federal agency. In the case of an application to establish a federal branch or federal agency, compliance with the publication procedures of the Comptroller shall satisfy the publication requirement of this section. Comments regarding the application should be sent to the Board and the Comptroller.

(3) Written comments. (i) Within 30 days after publication, as required in paragraph (b)(2) of this section, any person may submit to the Board written comments and data on an application.

(ii) The Board may extend the 30-day comment period if the Board determines that additional relevant information is likely to be provided by interested persons, or if other extenuating circumstances exist.

(4) Board action on application. (i) Time limits. (A) The Board shall act on an application from a foreign bank to establish a branch, agency, or commercial lending company subsidiary within 180 calendar days after the receipt of the application.

(B) The Board may extend for an additional 180 calendar days the period within which to take final action, after providing notice of and reasons for the extension to the applicant and the licensing authority.

(C) The time periods set forth in this paragraph (b)(4)(i) may be waived by the applicant.

(ii) Additional information. The Board may request any information in addition to that supplied in the application when the Board believes that the information is necessary for its decision, and may deny an application if it does not receive the information requested from the applicant or its home country supervisor in sufficient time to permit adequate evaluation of the information within the time periods set forth in paragraph (b)(4)(i) of this section.

(5) Coordination with other regulators. Upon receipt of an application by a foreign bank under this section, the Board shall promptly notify, consult with, and consider the views of the licensing authority.

(c) Standards for approval of U.S. offices of foreign banks—(1) Mandatory standards—(i) General. As specified in section 7(d) of the IBA (12 U.S.C. 3105(d)), the Board may not approve an application to establish a branch or an agency, or to establish or acquire ownership or control of a commercial lending company, unless it determines that:

(A) Each of the foreign bank and any parent foreign bank engages directly in the business of banking outside the United States and, except as provided in paragraph (c)(1)(iii) of this section, is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor; and

(B) The foreign bank has furnished to the Board the information that the Board requires in order to assess the application adequately.

(ii) Basis for determining comprehensive consolidated supervision. In determining whether a foreign bank and any parent foreign bank is subject to comprehensive consolidated supervision, the Board shall determine whether the foreign bank is supervised or regulated in such a manner that its home country supervisor receives sufficient information on the worldwide operations of the foreign bank (including the relationships of the bank to any affiliate) to assess the foreign bank's overall financial condition and compliance with law and regulation. In making such a determination, the Board shall assess, among other factors, the extent to which the home country supervisor:

(A) Ensures that the foreign bank has adequate procedures for monitoring and controlling its activities worldwide;

(B) Obtains information on the condition of the foreign bank and its subsidiaries and offices outside the home country through regular reports of examination, audit reports, or otherwise;

(C) Obtains information on the dealings and relationship between the foreign bank and its affiliates, both foreign and domestic;

(D) Receives from the foreign bank financial reports that are consolidated on a worldwide basis, or comparable information that permits analysis of the foreign bank's financial condition on a worldwide, consolidated basis;

(E) Evaluates prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis.

(iii) Determination of comprehensive consolidated supervision not required in certain circumstances. (A) If the Board is unable to find, under paragraph (c)(1)(i) of this section, that a foreign bank is subject to comprehensive consolidated supervision, the Board may, nevertheless, approve an application by the foreign bank if:

(1) The home country supervisor is actively working to establish arrangements for the consolidated supervision of such bank; and

(2) All other factors are consistent with approval.

(B) In deciding whether to use its discretion under this paragraph (c)(1)(iii), the Board also shall consider whether the foreign bank has adopted and implemented procedures to combat money laundering. The Board also may take into account whether the home country supervisor is developing a legal regime to address money laundering or is participating in multilateral efforts to combat money laundering. In approving an application under this paragraph (c)(1)(iii), the Board, after requesting and taking into consideration the views of the licensing authority, may impose any conditions or restrictions relating to

the activities or business operations of the proposed branch, agency, or commercial lending company subsidiary, including restrictions on sources of funding. The Board shall coordinate with the licensing authority in the implementation of such conditions or restrictions.
(2) Additional standards. In acting on any application under this subpart, the Board may take into account:
(i) Consent of home country supervisor. Whether the home country supervisor of the foreign bank has consented to the proposed establishment of the branch, agency, or commercial lending company subsidiary;
(ii) Financial resources. The financial resources of the foreign bank (including the foreign bank's capital position, projected capital position, profitability, level of indebtedness, and future prospects) and the condition of any U.S. office of the foreign bank;
(iii) Managerial resources. The managerial resources of the foreign bank, including the competence, experience, and integrity of the officers and directors; the integrity of its principal shareholders; management's experience and capacity to engage in international banking; and the record of the foreign bank and its management of complying with laws and regulations, and of fulfilling any commitments to, and any conditions imposed by, the Board in connection with any prior application;
(iv) Sharing information with supervisors. Whether the foreign bank's home country supervisor and the home country supervisor of any parent of the foreign bank share material information regarding the operations of the foreign bank with other supervisory authorities;
(v) Assurances to Board. (A) Whether the foreign bank has provided the Board with adequate assurances that information will be made available to the Board on the operations or activities of the foreign bank and any of its affiliates that the Board deems necessary to determine and enforce compliance with the IBA, the BHC Act, and other applicable federal banking statutes.
(B) These assurances shall include a statement from the foreign bank describing the laws that would restrict the foreign bank or any of its parents from providing information to the Board;
(vi) Measures for prevention of money laundering. Whether the foreign bank has adopted and implemented procedures to combat money laundering, whether there is a legal regime in place in the home country to address money laundering, and whether the home country is participating in multilateral efforts to combat money laundering;
(vii) Compliance with U.S. law. Whether the foreign bank and its U.S. affiliates are in compliance with applicable U.S. law, and whether the applicant has established adequate controls and procedures in each of its offices to ensure continuing compliance with U.S. law, including controls directed to detection of money laundering and other unsafe or unsound banking practices; and (viii) The needs of the community and the history of operation of the foreign bank and its relative size in its home country, provided that the size of the foreign bank is not the sole factor in determining whether an office of a foreign bank should be approved.
(3) Additional standards for certain interstate applications. (i) As specified in section 5(a)(3) of the IBA (12 U.S.C. 3103(a)(3)), the Board may not approve an application by a foreign bank to establish a branch, other than a limited branch, outside the home state of the foreign bank under section 5(a)(1) or (2) of the IBA (12 U.S.C. 3103(a)(1), (2)) unless the Board:

(A) Determines that the foreign bank's financial resources, including the capital level of the bank, are equivalent to those required for a domestic bank to be approved for branching under section 5155 of the Revised Statutes (12 U.S.C. 36) and section 44 of the Federal Deposit Insurance Act (FDIA) (12 U.S.C. 1831u);
(B) Consults with the Department of the Treasury regarding capital equivalency;
(C) Applies the standards specified in section 7(d) of the IBA (12 U.S.C. 3105(d)) and this paragraph (c); and
(D) Applies the same requirements and conditions to which an application by a domestic bank for an interstate merger is subject under section 44(b)(1), (3), and (4) of the FDIA (12 U.S.C. 1831u(b)(1), (3), (4)); and
(ii) As specified in section 5(a)(7) of the IBA (12 U.S.C. 3103(a)(7)), the Board may not approve an application to establish a branch through a change in status of an agency or limited branch outside the foreign bank's home state unless:
(A) The establishment and operation of such branch is permitted by such state; and
(B) Such agency or branch has been in operation in such state for a period of time that meets the state's minimum age requirement permitted under section 44(a)(5) of the Federal Deposit Insurance Act (12 U.S.C. 183u(a)(5)).
(4) Board conditions on approval. The Board may impose any conditions on its approval as it deems necessary, including a condition which may permit future termination by the Board of any activities or, in the case of a federal branch or a federal agency, by the Comptroller, based on the inability of the foreign bank to provide information on its activities or those of its affiliates that the Board deems necessary to determine and enforce compliance with U.S. banking laws.
(d) Representative offices—(1) Permissible activities. A representative office may engage in:
(i) Representational and administrative functions. Representational and administrative functions in connection with the banking activities of the foreign bank, which may include soliciting new business for the foreign bank; conducting research; acting as liaison between the foreign bank's head office and customers in the United States; performing preliminary and servicing steps in connection with lending; 11 or performing back-office functions; but shall not include contracting for any deposit or deposit-like liability, lending money, or engaging in any other banking activity for the foreign bank;
11 See 12 CFR 250.141(h) for activities that constitute preliminary and servicing steps.
(ii) Credit approvals under certain circumstances. Making credit decisions if the foreign bank also operates one or more branches or agencies in the United States, the loans approved at the representative office are made by a U.S. office of the bank, and the loan proceeds are not disbursed in the representative office; and
(iii) Other functions. Other functions for or on behalf of the foreign bank or its affiliates, such as operating as a regional administrative office of the foreign bank, but only to the extent that these other functions are not banking activities and are not prohibited by applicable federal or state law, or by ruling or order of the Board.
(2) Standards for approval of representative offices. As specified in section 10(a)(2) of the IBA (12 U.S.C. 3107(a)(2)), in acting on the application of a foreign bank to establish a representative office, the

Board shall take into account, to the extent it deems appropriate, the standards for approval set out in paragraph (c) of this section. The standard regarding supervision by the foreign bank's home country supervisor (as set out in paragraph (c)(1)(i)(A) of this section) will be met, in the case of a representative office application, if the Board makes a finding that the applicant bank is subject to a supervisory framework that is consistent with the activities of the proposed representative office, taking into account the nature of such activities and the operating record of the applicant.
(3) Special-purpose foreign government-owned banks. A foreign government-owned organization engaged in banking activities in its home country that are not commercial in nature may apply to the Board for a determination that the organization is not a foreign bank for purposes of this section. A written request setting forth the basis for such a determination may be submitted to the Reserve Bank of the District in which the foreign organization's representative office is located in the United States, or to the Board, in the case of a proposed establishment of a representative office. The Board shall review and act upon each request on a case-by-case basis.
(4) Additional requirements. The Board may impose any additional requirements that it determines to be necessary to carry out the purposes of the IBA.
(e) Preservation of existing authority. Nothing in this subpart shall be construed to relieve any foreign bank or foreign banking organization from any otherwise applicable requirement of federal or state law, including any applicable licensing requirement.
(f) Reports of crimes and suspected crimes. Except for a federal branch or a federal agency or a state branch that is insured by the Federal Deposit Insurance Corporation (FDIC), a branch, agency, or representative office of a foreign bank operating in the United States shall file a suspicious activity report in accordance with the provisions of §208.62 of Regulation H (12 CFR 208.62).
(g) Management of shell branches. (1) A state-licensed branch or agency shall not manage, through an office of the foreign bank which is located outside the United States and is managed or controlled by such state-licensed branch or agency, any type of activity that a bank organized under the laws of the United States or any state is not permitted to manage at any branch or subsidiary of such bank which is located outside the United States.
(2) For purposes of this paragraph (g), an office of a foreign bank located outside the United States is “managed or controlled” by a state-licensed branch or agency if a majority of the responsibility for business decisions, including but not limited to decisions with regard to lending or asset management or funding or liability management, or the responsibility for recordkeeping in respect of assets or liabilities for that non-U.S. office, resides at the state-licensed branch or agency.
(3) The types of activities that a state-licensed branch or agency may manage through an office located outside the United States that it manage or controls include the types of activities authorized to a U.S. bank by state or federal charters, regulations issued by chartering or regulatory authorities, and other U.S. banking laws, including the Federal Reserve Act, and the implementing regulations, but U.S. procedural or quantitative requirements that may be applicable to the conduct of such activities by U.S. banks shall not apply.
(h) Government securities sales practices. An uninsured state-licensed branch or agency of a foreign bank that is required to give notice to the Board under section 15C of the Securities Exchange Act of

1934 (15 U.S.C. 78o–5) and the Department of the Treasury rules under section 15C (17 CFR 400.1(d) and part 401) shall be subject to the provisions of 12 CFR 208.37 to the same extent as a state member bank that is required to give such notice.
(i) Protection of customer information and consumer information. An uninsured state-licensed branch or agency of a foreign bank shall comply with the Interagency Guidelines Establishing Information Security Standards prescribed pursuant to sections 501 and 505 of the Gramm-Leach-Bliley Act (15 U.S.C. 6801 and 6805) and, with respect to the proper disposal of consumer information, section 216 of the Fair and Accurate Credit Transactions Act of 2003 (15 U.S.C. 1681w), set forth in appendix D–2 to part 208 of this chapter.
(j) Procedures for monitoring Bank Secrecy Act compliance.
(1) Establishment of Compliance Program. Except for a Federal branch or a Federal agency or a state branch that is insured by the FDIC, a branch, agency, or representative office of a foreign bank operating in the United States shall, in accordance with the provisions of §208.63 of the Board's Regulation H, 12 CFR 208.63, develop and provide for the continued administration of a program reasonably designed to assure and monitor compliance with the provisions of subchapter II of chapter 53 of title 31, United States Code, the Bank Secrecy Act, and the implementing regulations promulgated thereunder by the Department of the Treasury at 31 CFR part 103. The compliance program shall be reduced to writing, and either:
(i) Approved by the foreign bank's board of directors and noted in the minutes, or
(ii) Approved by a delegee acting under the express authority of the board of directors to approve the Bank Secrecy Act compliance program.
(2) Customer identification program. Except for a federal branch or a federal agency or a state branch that is insured by the FDIC, a branch, agency, or representative office of a foreign bank operating in the United States is subject to the requirements of 31 U.S.C. 5318(l) and the implementing regulation jointly promulgated by the Board and the Department of the Treasury at 31 CFR 103.121, which require a customer identification program.[23]

The Basle Committee continues to work on cross-border banking issues. At the beginning of 2003 the Committee's Working Group on Cross-Border Banking published two papers: one on Shell Banks and booking offices,[24] and the other on Parallel-owned banking structures.[25] Shell banks and parallel-owned structures raise concerns about whether effective consolidated supervision is occurring. Here are some excerpts from the Shell Banks paper:

[23] 66 FR 53474, Oct. 26, 2001, as amended at 68 FR 35112, May 9, 2003; 69 FR 77618, Dec. 28, 2004; 71 FR 13936, Mar. 20, 2006

[24] http://www.bis.org/publ/bcbs95.pdf

[25] http://www.bis.org/publ/bcbs94.pdf

For the purposes of this paper, shell banks are banks that have no physical presence (i.e. meaningful mind and management) in the country where they are incorporated and licensed, and **are not affiliated to any financial services group that is subject to effective consolidated supervision**. The mind and management are located in another jurisdiction, often located in the offices of an associated entity or sometimes in a private residence. Typically, a shell bank maintains nothing but a registered agent in its country of incorporation, with the agent having little or no knowledge of the day-to-day operations of the bank, and simply providing an address for legal service in the jurisdiction. Such structures are a particular feature of some offshore centres.

Since a shell bank is not affiliated with a supervised financial services group, the licensing authority has sole responsibility for its supervision. However, with mind and management located in another jurisdiction, the supervisor is not in a position to supervise the bank (e.g. conduct on-site examination of operations or interface routinely with management) in accordance with the Core Principles. For its part, the supervisory authority in the country from which the bank is run is generally unaware that the bank exists and is being managed from within its jurisdiction. Shell banks conforming to this description frequently have been involved in illegal or suspicious financial activities. The Committee's *Customer Due Diligence for banks* (2001) paper recommended that banks should refuse to enter into or continue a correspondent banking relationship with shell banks located in foreign jurisdictions.

The working group is aware that issues raised by shell banks are being addressed in other national and international fora. A few offshore jurisdictions have recognised the potential problems and have ceased issuing licences to such entities, and have required existing ones either to relocate their principal office to the home country, or to close down altogether.

Shell banks pose serious obstacles to effective supervision, and there are no exceptional arrangements that can be put into place to achieve effective regulatory oversight. To be in line with the Core Principles, supervisory authorities should no longer approve the establishment of shell banks or accept their continued operation.

Where shell banks already exist, supervisors should set a short deadline (of less than one year) for banks to establish a meaningful mind and management in their jurisdiction, after which time their licences should be withdrawn if they have not complied. The relocation of mind and management should be genuine and not cosmetic, and should permit the supervisor to apply the full range of supervisory tools in accordance with the Core Principles.

Booking branches are offshore branches which are part of a bank regulated by a home country supervisor, and they may be used to avoid regulatory restrictions. For example the paper notes that US banks may use Cayman Islands and Bahamas booking offices to avoid restrictions on banks paying interest on US based commercial checking accounts. If funds are swept and held outside the US overnight the restrictions do not apply. If a booking branch is managed from the jurisdiction where the home supervisor is based the home country supervisor can supervise the bank. However booking branches may be managed from elsewhere:

...the concern is with booking branches managed or controlled from a third jurisdiction that is neither the home jurisdiction nor the jurisdiction in which they are licensed. Mind and management may be located within a supervised branch, a subsidiary of the parent bank, a sister institution or an unsupervised non-bank institution in the third jurisdiction. In practice, this third jurisdiction will tend most commonly to be the US where the vast majority of booking branches of European and other foreign banks are managed through New York offices. The 1996 paper on the *Supervision of Cross-border Banking* expressed concern that such booking branches may escape supervision both by the licensing jurisdiction and by the supervisor in the third jurisdiction....

The Working Group recommended that the various supervisors involved should work together in such contexts. Booking branches should be licensed in accordance with Basle Principles, and the licensing authority for the booking branch and the home supervisor should work together. The Working Group also says that "[b]ooking branches with mind and management exercised by an unregulated entity in a third country cannot be supervised effectively in line with these principles, and should be prohibited." The paper on parallel banks is attached to the back of this handout.

Regulations under the Patriot Act[26] prohibit US financial institutions from having correspondent accounts with shell banks.
Remember that the IMF has a program for monitoring compliance with standards and codes which includes the Basle Committee's banking principles.[27]

ARE BANKS DIFFERENT FROM OTHER FINANCIAL INSTITUTIONS ?

We have noticed that banks rely on other financial institutions to acquire credit risk from them by means of loan sales, loan participations and credit default swaps, and that this type of activity may have some implications for financial stability. At the beginning of the semester we saw that money services businesses (which are not regulated as banks) are subject to some similar rules (in particular in relation to money laundering) and that they do compete with banks in some ways (and that banks are competing with msbs). Banks are subject to different regulatory regimes from other financial institutions. But there is some blurring between the

[26] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001 (Public Law 107-56)

[27] *See. e.g.*, http://www.imf.org/external/np/rosc/rosc.asp

functions banks and other financial institutions perform. In **Essar Steel v the Argo Fund** [28], a decision excerpted in Packet 5 of the course materials, the UK Court of Appeal considered whether a hedge fund was a financial institution for the purposes of a provision in the LMA standard form syndicated loan agreement limiting loan transfers.

Earlier this year, Marl Olson[29] argued that banks are special:[30]

Much has changed in the banking landscape since Corrigan wrote his essay twenty-four years ago. Significant increases in international capital flows among bank and nonbank entities, in addition to a broad range of specialized financial instruments mean banks can no longer be considered the only source of transaction accounts. Except for their access to the Federal Reserve discount window, banks are no longer the dominant provider of liquidity for other financial industries. But banks remain the key access point to the dominant wholesale payments network, and they still provide federally insured checking and savings deposits. With the rise of new financial services, products, and techniques, moreover, banks have expanded their role in providing liquidity in more indirect ways, for example, through securitization of loans and backup commitments to securitization vehicles and other capital-markets instruments. Even when banks may not be "special" or unique providers in a particular market, banks have proven themselves to be formidable competitors and innovators--which only reinforces banks' importance in the proper functioning of our financial system. In short, the public's trust and confidence in banking continue to be vital to our financial well-being.
Banks provided considerable credit in the aftermath of the September 11 attacks, when financial flows were slowed by operational problems. To be sure, banks were able to provide this credit in part because of the huge injection of liquidity provided by the Federal Reserve. But that is a key role for banks in a crisis: to obtain funds--through the discount window or from open market operations, if necessary--and to channel them to those needing funds, based on an assessment of their creditworthiness. Banks' access to the discount window and the payments system, as well as their ongoing relationships with customers and their credit-evaluation skills, allow them to play this role. During a crisis, those banks that play critical roles in the payments system are especially important. As a result, these banks are expected to be very resilient. Though banks now have a smaller role in transmitting monetary policy, they still help to transmit policy actions by arbitraging between the federal funds market and other money markets.

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

[29] At the time Mark Olson was a Governor of the Federal Reserve Board. He resigned in June 2006 in order to become Chairman of the Public Company Accounting Oversight Board. See http://www.pcaobus.org/About_the_PCAOB/The_Board/index.aspx .

[30] See http://www.bis.org/review/r060322c.pdf . Mr. Olson refers to an essay written by Gerald Corrigan in 1982: “Are Banks Special” available at http://woodrow.mpls.frb.fed.us/pubs/ar/ar1982.cfm?js=0

US: DUAL BANKING REGULATION

In the US, banks may be chartered by the states or by the Office of the Comptroller of the Currency (OCC). Banks chartered by the OCC are known as national banks. The OCC also regulates federal branches and agencies of foreign banks. This separation of functions between the states and the federal authorities is sometimes problematic as states may want to impose rules on banks carrying on business on their territory and the federal authorities may be sensitive about issues of pre-emption in relation to national banks. The following **excerpt from a speech[31] by Mark W. Olson** discusses whether dual banking regulation is a good thing or not:

Importance of the Dual Banking System...

... the significance of the uniquely American dual banking system. Our country's founders established a federal system of government, dividing power and responsibilities between the state governments and the central government. Perhaps less well known to the public is that, since the Civil War, our banking system has developed along similar lines. State banks were, of course, first. But the dynamic tension between centralization and decentralization in U.S. banking is as old as the debate between Thomas Jefferson and Alexander Hamilton over the First Bank of the United States. For a time, after the demise of the Second Bank of the United States in 1836, the forces of state banking were in ascendance. Then, with the passage of the National Bank Act of 1863, nationally chartered banks arrived on the scene. At the time, with the tax on state bank notes, some thought state banks would fade away. Instead, they innovated--by emphasizing demand deposits--and prospered. In typically American fashion, the compromise that has been worked out over time is to have it both ways. We have nationally chartered banks supervised by the federal government and state-chartered banks supervised by both state and federal regulators. The Federal Reserve System itself also reflects this American preference for dispersal of authority. In 1913 the Congress, fearful of central authority, attempted to create a set of regional central banks. Today the twelve Reserve Banks, with the Board of Governors in Washington, provide the regional representation and authority so dear to the American psyche.

Over the years, the dual banking system has provided many innovations. Forced to find a substitute for the issuance of state bank notes that were taxed out of the market by the National Bank Act of 1863, state banks pioneered demand deposits. Much more recently, a state-chartered bank invented the NOW account, which was the opening shot in the long campaign to remove national controls from interest rates on deposits. And the 1994 interstate branching statute was essentially the epilogue to the interstate banking movement, which had begun a decade before then through the establishment of regional interstate compacts. If memory serves, forty-nine of the fifty states had passed some form of interstate banking legislation before the federal government acted on this issue. After the 1994 Reigle-Neal Act, the state banking commissioners combined their efforts to provide for the orderly and consistent supervision of state banks with a multistate presence. I believe the results are a tribute

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

both to the resilience of state banking and, not incidentally, to the leadership of the Conference of State Bank Supervisors.

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

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

See also the following **speech by John Hawke**:[32]

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

From this reasoning flowed one of the most distinctive characteristics of the U.S. banking system. At its high water mark, in 1921, there were no fewer than 29,000 independent commercial banks in America. Even today, after decades of industry contraction, there are more than 8000 U.S. banking companies, a number not equaled anywhere else in the world...Viewed purely as an economic arrangement, this banking structure has probably never made much sense. Any system based on thousands of independent, mostly small, institutions might be viewed as a system inevitably lacking in stability and efficiency. But Americans were willing to sacrifice those qualities in a conscious trade off to preserve other values they cherished even more: competition, individual initiative, local responsiveness,

[32] At the time, John Hawke was the Comptroller of the Currency. He is currently a partner at Arnold & Porter. The speech is at http://www.occ.treas.gov/ftp/release/2002-80a.txt .

and opportunity. Branch banking, despite its real economic benefits, was seen as a threat to those values – and as a step toward financial concentration and monopoly. That's why branching and bank consolidation were systematically suppressed by state and federal laws – some of which remained in effect until just a few years ago.

Americans did not depend entirely on the structure of their banking system to curb potential abuses of banking power. Government oversight and enforcement were also viewed as essential. But here too there have been inhibitions. Americans have always been uneasy with the idea of government intervention in the economy. Our experience as a colony left our people with deep suspicions of government authority -- suspicions that linger to this day. The arrangements formalized in the U.S. Constitution, with its provisions for checks and balances and power sharing between the national government and the states, reflected these suspicions. Thus, in the same way – and for many of the same political reasons -- that U.S. banks were encouraged to proliferate, a system of multiple bank chartering and regulatory authorities arose. During the first half of the 19th century, the states dominated the field of banking. Each carried out its own program of bank chartering and supervision, reflecting wide variances in rigor and competence. The federal government's involvement was sporadic -- and generally unwelcome. Not until the American Civil War, which redefined the relationship between the central government and the states, did a federal presence become a permanent part of the U.S. banking system in the form of the Office of the Comptroller of the Currency and the national banking system, which our office supervises. I am proud to be the 28th person to hold the Office of the Comptroller of the Currency since our founding in 1863.

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

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

The decision to create the OCC as an independent agency was quite an extraordinary step, and it was one that reflected Congress's understanding of the importance of supervision in the nation's overall banking scheme. Although formally a "bureau" of the Treasury Department – indeed, until the 1970s, the Comptroller's offices were actually housed within the main Treasury building in Washington --

the OCC has always enjoyed considerable operational autonomy. Although appointed by the President with Senate confirmation, the president cannot remove the Comptroller before the expiration of the statutory five-year term without providing to the Senate in writing a statement of his reasons for doing so.

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

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

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

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

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

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

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

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

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

We are often asked to explain why this complicated regulatory structure arose – and why we have not attempted systematically to simplify it. The question of origins has a relatively straightforward answer. I have already spoken of Americans' enduring suspicion of concentrated political authority and their belief that establishing multiple and competing government bureaucracies would serve to check their ambitions and excesses. Thus, when the Federal Reserve System was created in

1914 – becoming the second federal agency with a bank supervisory mission – Congress simply layered it on top of the existing supervisory structure and parceled supervisory authority between the new Fed and the OCC. The same pattern held in 1933, when the FDIC – the third of the federal banking agencies -- was created.

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

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

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

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

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

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

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

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

States make it clear they are competing to attract banks to charter with them. They say that the state banking officials will be accessible, that the charges they impose are lower than the OCC's charges, and that the regulators and rules are local.[33]

In addition states often have parity statutes which allow state banks to have many of the benefits they would derive from a national charter. Here is the Florida statute (**Section 655.061, Florida Statutes**):

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

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

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

This question may matter. Recently states have introduced legislation regulating what banks do within their territory. In particular, states have enacted statutes to control predatory lending.[34] Predatory lenders impose unfair terms on their customers. Often the loans are mortgage loans and the result of the loan terms is that the borrowers lose their homes.[35] The statutes tend to be drafted to cover lending within the state rather than lending by state chartered banks. This makes some sense if borrowers cannot easily distinguish between state chartered and national banks and therefore cannot easily work out what rules would regulate predatory lending. However, national banks have objected to being subjected to these state laws on the basis that they are pre-empted. A major concern underlying the objection is the impact of state predatory lending laws on securitizations. Rating agencies have addressed these issues. For example, Standard & Poor's stated in 2003 that it considered whether predatory lending statutes provide for assignee liability, whether the loan categories affected are clearly defined, what penalties apply and how clear the statute is (including safe harbors).[36] Rating agencies and lenders suggest that if state statutes make it hard for lenders to securitize loans the legislation may be counter-productive and cut off access to credit for borrowers:

> GAFLA, with its complicated structure, ambiguous provisions and undefined terms, has created uncertainty, and the secondary market has reacted strongly and negatively. The reaction was to be expected on 'high cost' loans, as the large, national buyers of home loans such as Fannie Mae and Freddie Mac do not buy those loans. However, the market has also reacted negatively to 'covered' loans primarily due to the uncertainty created by the wording of the Act. No other state or federal anti-predatory lending laws include a

[34] Sometimes described as "abusive lending". *See*, *e.g.*, OCC notice for Request of Pre-emption Determination or Order relating to the Georgia Fair Lending Act at http://www.occ.treas.gov/fr/fedregister/68fr8959.pdf

[35] *See, e.g.*, Center for Responsible Lending, CRL Comment on OCC Working Paper #2006-1, "Foreclosures of Subprime Mortgages in Chicago" (Sept. 15, 2006) *available at* http://www.responsiblelending.org/pdfs/Response-OCC-Chicago_Foreclosures.pdf (to date, anti-predatory lending laws have typically aimed to reduce the stripping of home equity that harms many subprime borrowers, not just those who lose their homes to foreclosure. Prepayment penalties (which trap borrowers in higher-cost loans than that for which they may qualify) and unaffordable balloon payments can strip thousands of dollars in equity away from an individual subprime borrower, regardless of whether such terms result in foreclosure.")

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

> category of mid-priced loans in their statutes, and loans made in Georgia will continue to be treated with suspicion by the secondary market. The national buyers of mortgage loans have changed their underwriting standards and now require lenders to agree to take back any loans made under GAFLA if a compliance failure is found – even years after the loan was closed, sold or even paid off.[37]

In January 2004 the OCC issued two rules: one on Bank Activities and Operations; Real Estate Lending and Appraisals[38] and the other on Bank Activities and Operations.[39] These rules attempt to delineate when state rules may impact national banks and when they may not. Federal Appeals Courts in the 2nd, 9th, 6th and 4th Circuits have recently held that state regulators may not exercise visitorial powers over national banks and their subsidiaries.[40] In **Wachovia v Burke** the 2nd Circuit said :

Even if the policy determination were not manifest in section 7.4006, it is extensively developed in the OCC's recent revision of 12 C.F.R. part 34, which was designed to demarcate more clearly what state laws are and are not preempted with respect to real estate lending activities. See Bank Activities and Operations; Real Estate Lending and Appraisals...There the OCC explained that 12 U.S.C. §24 (Seventh) provides a "flexible grant of authority" to national banks to further "Congress's long-range goals in establishing the national banking system." ... The OCC noted that achievement of these goals requires national banks "whose powers are dynamic and capable of evolving" because "the financial services marketplace has undergone profound changes" in recent years.. The OCC specifically observed that "changes in applicable law also have contributed to the expansion of markets for national banks and their operating subsidiaries." .. The OCC found, however, that "national banks' ability to conduct operations to the full extent authorized by Federal law has been curtailed as a result" of increasing state efforts to regulate bank activities... As an example, the OCC pointed to its recent ruling that the Georgia Fair Lending Act ("GFLA") was preempted from applying to national banks and their operating subsidiaries... The OCC stated that "the GFLA caused secondary market participants to cease

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37 The Georgia Bankers Association White Paper, Georgia Fair Lending Act. The Unintended Consequences 5 (Jan. 2003) *available at* http://www.gabankers.com/issuespredatorylendingwhitepaper.pdf . See also http://www.gabankers.com/issuesstate2003final.htm#Predatory%20Lending

38 69 Fed. Reg. 1904 (Jan 13, 2004) *available at* http://a257.g.akamaitech.net/7/257/2422/14mar20010800/edocket.access.gpo.gov/2004/pdf/04-586.pdf

39 69 Fed. Reg 1895 (Jan 13, 2004) *available at* http://a257.g.akamaitech.net/7/257/2422/14mar20010800/edocket.access.gpo.gov/2004/pdf/04-585.pdf

40 Wachovia v Burke, 414 F.3d 305 (2d cir. 2005); Wells Fargo Bank v Boutris, 419 F.3d 949 (9th Cir 2005); Wachovia v Watters, 431 F.3d 556 (6th Cir. 2005); National City Bank of Indiana v Turnbaugh 463 F.3d 325 (4th Cir. 2006).

purchasing certain Georgia mortgages and many mortgage lenders to stop making mortgage loans in Georgia. National banks have also been forced to withdraw from some products and markets in other states as a result of the impact of state and local restrictions on their activities." ..
the OCC regulations reflect a consistent and well-reasoned approach to preempting state regulation of operating subsidiaries so as to avoid interference with national banks' exercise of their powers under [the statute]and their ability to use operating subsidiaries in the dynamic market of banking and real estate lending. While the Commissioner and Attorneys General Amici raise legitimate concerns about states' interest in protecting consumers and about the OCC's ability to regulate operating subsidiaries effectively, the OCC has responded to these concerns in its rulemaking...The states' proper recourse at this point is to Congress. We must defer to the OCC's authorized and reasonable implementation of the NBA.

In **Wells Fargo v Boutris**, the 9th Circuit said:

Just as the Comptroller's authority to regulate national banks' leasing activities is inherent in his authority to interpret the "incidental powers" provision to allow such leasing in the first place, his authority to regulate operating subsidiaries also follows from the OCC's authority to allow such entities.
Further, the OCC operating subsidiary regulations ..quite directly address the reach of the national banks' "incidental powers" authority to create and conduct their business through such entities. Those regulations..restrict the range of activities that operating subsidiaries may conduct to those in which their parent banks may engage..and state that such subsidiaries are subject to the same federal rules and standards "that apply to the conduct of such activities by its parent national bank." ..These provisions ensure that the decision to conduct banking activities through subsidiaries neither expands the national banks' scope of activities nor undermines the authority of the OCC to regulate those activities. By establishing these principles, the regulations circumscribe the decision to use operating subsidiaries so that it remains only "incidental" to the "business of banking."
In regulating the conduct of operating subsidiaries, moreover, the OCC is regulating only those activities it is explicitly authorized to regulate under the Bank Act. For federal regulatory purposes, in other words, the OCC is treating each operating subsidiary for the most part as if it were a national bank itself, conducting the same activities. In the latter instance, of course, the OCC's regulatory authority is unquestioned. As we concluded twenty-eight years ago, "whatever the scope of such [incidental] powers may be, we believe the powers of national banks must be construed so as to permit the use of new ways of conducting the very old business of banking.”..
...Operating subsidiaries are subject to no less and no more governmental regulation, state and federal, than national banks. The connection between the OCC's substantive determinations regarding the authority of national banks to conduct their business through operating subsidiaries and the preemption regulation is thus close and logical. We are therefore convinced that once the OCC's authority to allow the creation of and to regulate operating subsidiaries as it has done is established, its authority to displace contrary state regulation where the Bank Act itself preempts contrary state regulation of national banks follows.

The 9th Circuit said that in addition to the OCC's rules pre-empting a state's exercise of visitorial jurisdiction over operating subsidiaries of national banks, the rules also prevented California from requiring an operating subsidiary of a national bank to be licensed to carry on mortgage business in California.

Standard and Poor's has suggested that the OCC's rules do not go far enough and that there remain some issues with some state predatory lending statutes:

...the OCC declined to exercise its perceived authority to occupy the field with regard to the real estate lending activities of National Banks. Instead, in the Rule, the OCC provides that "state laws that obstruct, impair, or condition a national bank's ability to fully exercise its federally authorized real estate lending powers do not apply to national banks." The Rule then lists examples of state laws that are and are not preempted by the Rule. Second, the Rule was silent on the issue of whether assignee liability provisions contained in state laws and regulations (including anti-predatory lending laws) apply to assignees of loans originated by National Banks..Finally, the Rule did not address the extent to which servicing restrictions in state anti-predatory lending laws could directly apply to purchasers or assignees of loans originated by National Banks.[41]

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

In a recent California decision in **Hood v Santa Barbara Bank and Trust** [42] the appeals court held that the OCC's preemption regulations did not pre-empt claims by private parties under California's consumer protection laws. Here is an excerpt from the decision:

The visitorial powers doctrine applies to government actions. That doctrine provides that no national bank "shall be subject to any visitorial powers except as authorized by Federal law, vested in the courts of justice or such as shall be, or have been exercised or directed by Congress . ..." ..Visitorial powers include regulating and supervising activities permitted pursuant to federal banking law (e.g., examinations and inspections of bank records) and enforcing compliance with any applicable federal or state laws concerning those activities...
Historically, the "visitations" prohibited by the visitorial powers doctrine involve the act of a government... "Because 'visitation' assumes the act of a sovereign body, private actions brought by individuals against

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

[42] 143 Cal. App. 4th 526 (2006). The claims related to tax refund anticipation loans. On these loans generally, see http://www.responsiblelending.org/issues/refund/ . The decision is also available here: http://www.abanet.org/buslaw/committees/CL230044pub/materials/20061003000000.pdf

banks in pursuit of personal claims ordinarily are outside the scope of visitorial powers rules.".. The language of the OCC's visitorial powers regulation explicitly contemplates state action: "State officials may not exercise visitorial powers with respect to national banks ... except in limited circumstances authorized by federal law." ..

Appellants brought their action as private parties seeking damages for financial losses as well as declaratory and injunctive relief under the "private attorneys general" statute. As the California Supreme Court recognized in People v. Pacific Land Research Co... there are fundamental differences between an action filed by a public prosecutor seeking injunctive relief and civil penalties and a consumer class action filed by a private party... The "filing of a UCL [class] action by a private plaintiff does not confer on that plaintiff the stature of a prosecuting officer, and the fact that the plaintiff may be acting as a so-called private attorney general is irrelevant ... ." .. Actions brought by private plaintiffs are outside the scope of the visitorial powers regulation.

In discussing visitorial powers, the trial court concluded that appellants' action is fundamentally regulatory. "[T]he purpose of [appellants'] action is to regulate cross-collection agreements, not to adjudicate an individual dispute." We do not agree that by permitting appellants' claims to proceed, the state is regulating Santa Barbara's conduct. Appellants' ability to sue respondents under the UCL, under the CLRA, for conversion, and for violating debt collection laws does not interfere with what respondents may do or how they may operate their banking business. Put another way, while the state cannot dictate to respondents how they can or cannot operate, it can insist that, however respondents choose to operate, they do so without violating debt collection laws and using deceptive business practices...

Appellants seek not only declaratory and injunctive relief but also the recovery of damages for class members under several theories. Appellants allege class members suffered substantial economic losses as a result of respondents' seizures of their tax refunds. The visitorial powers doctrine does not preclude appellants from pursuing their claims..

Both the deposit-taking regulation and the lending regulation "exempt" or "save" state contract, tort, and debt collection laws from preemption. These exemptions apply to the extent that such laws only incidentally affect the exercise of national banks' deposit-taking (or non-real-estate-lending) powers or are otherwise consistent with the banks' deposit-taking (or non-real-estate-lending) powers... Based on the record before us, it does not appear that the state's contract, tort or debt collection laws have more than an incidental effect on the exercise of national banks' deposit-taking (or non-real-estate-lending) powers or are otherwise inconsistent with the banks' deposit-taking (or non-real-estate-lending) powers....

Some of the legal obligations that appellants seek to enforce are created by federal law. Appellants seek to redress the violation of federal standards that have been adopted as part of California law. For example, appellants allege that respondents violated Civil Code section 1788.17 of the Rosenthal Fair Debt Collection Practices Act, which requires debt collectors to comply with the federal Fair Debt Collection Practices Act. In addition, title 12 United States Code section 4302(e) prohibits depository institutions from making "any advertisement, announcement, or solicitation relating to a deposit account that is inaccurate or misleading or that misrepresents its deposit contracts." Appellants allege that "[d]efendants deceive and mislead consumers when they induce consumers to sign RAL Agreements

containing the [cross-collection provision]"; that defendants have violated Civil Code section 1770, subdivision (a)(5) because they have represented that the RAL's are a form of tax refund when they are loans subject to seizure by the lender to pay off alleged prior RAL debts of individual taxpayers; and that they have violated Civil Code section 1770, subdivision (a)(14) by representing that they have rights and remedies that are prohibited by law. The facts alleged in the complaint support a legal theory of liability for false and misleading advertising based on the predicate act(s) of violation of federal law regarding required disclosures and prohibited misleading or misrepresentative advertising... Further, title 15 United States Code section 1692e provides that "[a] debt collector may not use any false, deceptive, or misleading representation or means in connection with the collection of any debt." The complaint's alleged facts would support a legal theory of liability for violation of section 1692e also.
An act or practice is "unfair competition" under the UCL if it is forbidden by law...The UCL "borrows" violations of other laws, including federal laws, and makes them actionable as unlawful business practices...Therefore, a violation of federal law may serve as a predicate for a UCL action. The OCC has recognized that the UCL applies to national banks..
The relevant OCC regulations preempt those state laws that "obstruct, impair, or condition" a national bank's ability to exercise its federally authorized deposit-taking and lending powers. ..Here, appellants' CLRA, UCL, and Rosenthal Fair Debt Collection Practices Act's causes of action allege facts that would support a cause of action based on violations of federal law that apply to respondents regardless of state law. Thus, those causes of action are not preempted because they do not impose any substantial limitations upon, or "obstruct, impair, or condition" a bank's actions...

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

Our jurisdiction over national banks and their subsidiaries also does not deprive state regulators of a role in protecting consumers in their states, and we welcome the opportunity to work cooperatively with them to further that goal. We have invited state authorities to refer consumer complaints concerning national banks to the OCC, and to bring to our attention concerns that any national bank is engaged in unfair, deceptive, abusive or predatory practices. We have set up special procedures to handle and track referrals from state authorities.
The OCC and the states already cooperate extensively in many respects, referring consumer complaints to the appropriate regulator of the entity generating the complaint, and we welcome additional opportunities to collaborate. We issued a new Advisory Letter to national banks just last week clarifying our expectations about how they should handle consumer complaints that are forwarded to them from state agencies and departments. Personally, I hope that we can move beyond the rhetoric of the current controversy and leverage off existing cooperative processes to put our collective resources to work to maximize their coverage.... Preemption provides benefits to banks and thrifts in the form of efficiencies that flow from uniform, consistent, and predictable standards that apply wherever in the nation an institution does business. In other words, you know you can run a better railroad if the track gauge doesn’t change with every state and county line that you cross. But with preemption also comes responsibility, and this is a timely opportunity for all bankers to recommit to the highest standards of

customer service, integrity, and fair play in their business. The *very best* way to counter the controversies that I have just discussed and preserve the benefits of preemption is for bankers to be leaders in responsible corporate behavior and exemplary customer treatment. That way, both bankers and their customers come out winners. [43]

The EU has similar issues about when Member States can impose general good rules on banks established in other states. The EU has adopted directives on banking which allow banks established in one Member State to offer services to customers in other Member States without the need to be established there. And EU banks established in one Member State can establish branches in other Member States.[44] The directives limit Member States' ability to regulate banks established in other Member States, but Member States have in place many rules (like the state predatory lending statutes in the US) that they want to apply to banks from other Member States. In 1997 the **EU Commission adopted a Communication on the "general good"** in the context of banking, which stated:[45]

The Commission published ... a draft communication which marked the launch of a broad consultation. Following the publication of this Communication, the Commission received numerous contributions from all the circles concerned (Member States, professional associations, credit institutions, consumer organizations, lawyers, etc.). It also organized hearings with all the parties who had taken part in the written consultation.
The Commission came to realize in the course of this consultation that there was still some uncertainty regarding the interpretation of basic concepts such as freedom to provide services and the interest of the general good. This uncertainty is such as to deter certain credit institutions from exercising the very freedoms which the Second Directive sets out to promote and, consequently, to hamper the free movement of banking services within the European Union.
The Commission therefore deems it desirable to restate in a Communication the principles laid down by the Court of Justice and to set out its position regarding the application of those principles to the specific problems raised by the Second Banking Directive. Its objective in publishing this Communication is to explain and clarify the Community rules. It provides all the parties concerned - national administrations, traders and consumers - with a reference document defining the legal framework within which, in the view of the Commission, banking activities benefiting from mutual recognition should be pursued.

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

[44] See generally http://ec.europa.eu/internal_market/bank/index_en.htm.

[45] http://ec.europa.eu/internal_market/bank/docs/sec-1997-1193/sec-1997-1193_en.pdf

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

In Italy, the Criminal Code stipulates usury as a crime, but it does not include a precise definition of what constitutes a usurious rate of interest. Such a definition was laid down in Law N˚ 108 of 7th March 1996. Decree-Law N˚ 394 of 29/12/2000, later converted into Law N˚ 24 of 24th February 2001, established that the nature of interest rates has to be assessed having regard to the time when the contract was signed. However, for fixed-rate loans pending at the end of 2000 interest rates cannot be higher than the average yield on national bonds (BTP) for the period 1996-2000. In practice, this means that the courts could consider as usurious interest rates of more than 9.96% per year, whereas at the time the 1996 law entered into force the normal rate on the market, was significantly higher, at 11%. This could have an impact on loans made by banks of other Member States that had been defined by the previous law as "non-usurious".
The effect of this measure, in the Commission's view, is to dissuade banks from other EU countries from offering their services in Italy. As such, the law violates the EC Treaty by constituting an unjustified restriction of the freedom to provide services (Article 49), the right of establishment (Article 43), and the free movement of capital (Article 56), as well as the Directive laying down Internal Market rules for banks (2000/12/EC).[46]

The Commission announced in April 2006 that it was taking enforcement action against France in relation to a French rule which prohibits interest bearing current accounts:[47]

The European Commission has decided to ask France formally to amend its legislation ('Code Monétaire') that prohibits banks from offering interest on current accounts to their customers. The upshot of the legislation is that banks from another Member State which have a branch or subsidiary in France cannot offer banking services under the same conditions as in their home Member State. The Commission considers that the legislation is in breach of the EC Treaty rules on the freedom of establishment (Article 43) and does not correctly implement the Banking Directive's provisions on single licences. It has thus issued a reasoned opinion, this being the second stage of the infringement procedure laid down in Article 226 of the EC Treaty. In the absence of a satisfactory reply from France within two months of receiving the reasoned opinion, the Commission may decide to refer the matter to the European Court of Justice.

The ECJ has previously addressed this issue in a decision in 2004, holding in **Caixa Bank v France** that the Member States were prohibited under the EC treaty from restricting

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

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

subsidiaries of banks established in other Member States from offering interest bearing “sight accounts” [48]:

7. It should be noted, as a preliminary point, that Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions (OJ 2000 L 126, p. 1) is not applicable in a case such as that at issue in the main proceedings, in particular because that directive does not refer to restrictions on the establishment of companies which, like Caixa-Bank, make use of freedom of establishment in a Member State as subsidiaries of credit institutions established in other Member States.
8. By its questions the national court essentially asks whether Article 43 EC precludes legislation of a Member State which prohibits a credit institution which is a subsidiary of a company from another Member State from remunerating sight accounts in euros opened by residents of the former Member State.
9. The freedom of establishment provided for in Article 43 EC, read in conjunction with Article 48 EC, is conferred both on natural persons who are nationals of a Member State and on legal persons within the meaning of Article 48 EC. Subject to the exceptions and conditions specified, it includes the right to take up and pursue all types of self-employed activity in the territory of any other Member State, to set up and manage undertakings, and to set up agencies, branches or subsidiaries...
10 The legal position of a company such as Caixa-Bank falls within the scope of Community law by virtue of the provisions of Article 43 EC.
11 Article 43 EC requires the elimination of restrictions on the freedom of establishment. All measures which prohibit, impede or render less attractive the exercise of that freedom must be regarded as such restrictions ...
12 A prohibition on the remuneration of sight accounts such as that laid down by the French legislation constitutes, for companies from Member States other than the French Republic, a serious obstacle to the pursuit of their activities via a subsidiary in the latter Member State, affecting their access to the market. That prohibition is therefore to be regarded as a restriction within the meaning of Article 43 EC.
13 That prohibition hinders credit institutions which are subsidiaries of foreign companies in raising capital from the public, by depriving them of the possibility of competing more effectively, by paying remuneration on sight accounts, with the credit institutions traditionally established in the Member State of establishment, which have an extensive network of branches and therefore greater opportunities than those subsidiaries for raising capital from the public.
14 Where credit institutions which are subsidiaries of foreign companies seek to enter the market of a Member State, competing by means of the rate of remuneration paid on sight accounts constitutes one of the most effective methods to that end. Access to the market by those establishments is thus made more difficult by such a prohibition.

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

15 While the French Government asserted at the hearing that there are forms of account comparable to sight accounts, such as 15-day accounts, which are not covered by the prohibition of remuneration and have helped credit institutions such as Caixa-Bank to compete with French credit institutions in raising funds from the public and increasing their market share in France, the Government conceded, however, that those accounts, unlike sight accounts, do not allow the use of bank cards or cheques. The prohibition at issue therefore entails a hindrance for credit institutions such as Caixa-Bank in their activity of raising capital from the public, which the existence of other forms of account with remunerated deposits cannot remedy.
16 The restriction on the pursuit and development of the activities of those subsidiaries resulting from the prohibition at issue is all the greater in that it is common ground that the taking of deposits from the public and the granting of credits represent the basic activities of credit institutions...
17 It is clear from settled case-law that where, as in the case at issue in the main proceedings, such a measure applies to any person or undertaking carrying on an activity in the territory of the host Member State, it may be justified where it serves overriding requirements relating to the public interest, is suitable for securing the attainment of the objective it pursues and does not go beyond what is necessary in order to attain it...
18 It must therefore be examined whether the grounds put forward by the French Government meet those criteria.
19 To justify the restriction on freedom of establishment resulting from the prohibition at issue, the French Government prayed in aid both the protection of consumers and the encouragement of medium and long-term saving.
20 It submits, first, that the prohibition at issue in the main proceedings is necessary for maintaining the provision of basic banking services without charge. Introducing remuneration for sight accounts would substantially increase the operating costs of banks, which, to recover those costs, would increase charges and introduce charges for the various banking services currently provided free, in particular the issuing of cheques.
21 It must be observed, however, that while the protection of consumers is among the overriding requirements that can justify restrictions on a fundamental freedom guaranteed by the EC Treaty, the prohibition at issue in the main proceedings, even supposing that it ultimately presents certain benefits for the consumer, constitutes a measure which goes beyond what is necessary to attain that objective.
22 Even supposing that removing the prohibition of paying remuneration on sight accounts necessarily entails for consumers an increase in the cost of basic banking services or a charge for cheques, the possibility might be envisaged inter alia of allowing consumers to choose between an unremunerated sight account with certain basic banking services remaining free of charge and a remunerated sight account with the credit institution being able to make charges for banking services previously provided free, such as the issuing of cheques.
23 As regards, next, the French authorities' concern to encourage long-term saving, it must be observed that, while the prohibition of remuneration on sight accounts is indeed suitable for encouraging medium and long-term saving, it nevertheless remains a measure which goes beyond what is necessary to attain that objective.

24 In the light of the above considerations, the answer to the questions referred for a preliminary ruling must be that Article 43 EC precludes legislation of a Member State which prohibits a credit institution which is a subsidiary of a company from another Member State from remunerating sight accounts in euros opened by residents of the former Member State.

Should Italy's usury rules apply to loans to Italians in Italy?[49] Should France be able to dictate the terms on which bank accounts may be offered in France?

[49] France liberalised its usury rules in 2003. See e.g. http://www.lw.com/resource/Publications/ClientAlerts/clientAlert.asp?pid=774