INTERNATIONAL FINANCE SPRING 2010

Materials Packet 7

BANKING REGULATION AND SECURITIES REGULATION COMPARED

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OBJECTIVES OF BANKING REGULATION AND SECURITIES REGULATION

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

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

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significant feature of securities regulation.

Form the perspective of the regulation of securities issuance by banks, if banking regulators regulate the safety and soundness of banks effectively we should perhaps not worry too much about having the SEC regulate the issuance of securities by banks.[2]

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

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

Here are **IOSCO's Core Principles of Securities Regulation**:[4]

This document sets out 30 principles of securities regulation, which are based upon three objectives of securities regulation. These are:
The protection of investors;
Ensuring that markets are fair, efficient and transparent;
The reduction of systemic risk.

The 30 principles need to be practically implemented under the relevant legal framework to achieve the

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

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

[4] *See* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD265.pdf . These core principles were published in 2008.

objectives of regulation described above. The principles are grouped into eight categories.

A. Principles Relating to the Regulator
1 The responsibilities of the regulator should be clear and objectively stated.
2 The regulator should be operationally independent and accountable in the exercise of its functions and powers
3 The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
4 The regulator should adopt clear and consistent regulatory processes.
5 The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.

B. Principles for Self-Regulation
6 The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.
7 SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

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

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

E. Principles for Issuers
14 There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.
15 Holders of securities in a company should be treated in a fair and equitable manner.
16 Accounting and auditing standards should be of a high and internationally acceptable quality.

F. Principles for Collective Investment Schemes

17 The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.

18 The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.

19 Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.

20 Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.

G. Principles for Market Intermediaries

21 Regulation should provide for minimum entry standards for market intermediaries.

22 There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.

23 Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.

24 There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

H. Principles for the Secondary Market

25 The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.

26 There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

27 Regulation should promote transparency of trading.

28 Regulation should be designed to detect and deter manipulation and other unfair trading practices.

29 Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.

30 Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

The **Basle Committee's**[5] **Core Principles for Effective Banking Supervision** , published in 2006, are set out below:

LIST OF CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION[6]

Preconditions for Effective Banking Supervision

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

Licensing and Structure

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

Prudential Regulations and Requirements

6. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

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[5] The Basle Committee on Banking Supervision was established in 1974 by the G10 central bank Governors as a forum for co-operation.

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

7. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.
8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.
9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.
10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.
11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.
12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.
14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision
16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision.
17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.
18. Banking supervisors must have a means of collecting, reviewing and analysing prudential reports

and statistical returns from banks on a solo and consolidated basis.
19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.
20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

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

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

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

Applying these principles can be complex due to the intricacies of domestic regulatory systems. As well as the issues of how responsibilities for different areas of financial regulation (securities, banking, insurance etc) may be split between different regulators within different national systems, different countries allocate responsibilities for banking supervision differently. In the US a number of different federal agencies currently have responsibilities in relation to banking regulation. The **Office of the Comptroller of the Currency** (OCC)[7] is the primary federal regulator for national banks.[8] The **Federal Reserve Board** (Fed)[9] is the main federal regulator for state-chartered banks which are members of the Federal Reserve System, and the **FDIC** (Federal Deposit Insurance Corporation)[10] 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[11] 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' 2006 **Joint Report on Differences in Accounting and Capital Standards Among the Federal Banking Agencies**:[12]

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

[8] 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).

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

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

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

[12] 71 Fed Reg 16776 (Apr. 4, 2006).

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**, 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.

12 USC § 3105

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

(1) Prior approval required

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

(2) Required standards for approval

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

(3) Standards for approval

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

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

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

(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.[13]

ARE BANKS DIFFERENT FROM OTHER FINANCIAL INSTITUTIONS ?

We have noticed that banks rely on other financial institutions to acquire credit risk from them by means of loan sales, loan participations and credit default swaps, and that this type of activity has some implications for financial stability. Banks are subject to different regulatory regimes from other financial institutions. But there is some blurring between the functions banks and other financial institutions perform. In **Essar Steel v the Argo Fund** [14] we saw that the UK Court of Appeal considered whether a hedge fund was a financial institution for the purposes of a provision in the LMA standard form syndicated loan agreement limiting loan transfers.

In 2006, Marl Olson, then a Governor of the Federal Reserve Board,[15] argued that banks are special:[16]

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

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[13] You can access Regulation K at http://www.federalreserve.gov/regulations/ .

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

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

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

access point to the dominant wholesale payments network, and they still provide federally insured checking and savings deposits. With the rise of new financial services, products, and techniques, moreover, banks have expanded their role in providing liquidity in more indirect ways, for example, through securitization of loans and backup commitments to securitization vehicles and other capital-markets instruments. Even when banks may not be "special" or unique providers in a particular market, banks have proven themselves to be formidable competitors and innovators--which only reinforces banks' importance in the proper functioning of our financial system. In short, the public's trust and confidence in banking continue to be vital to our financial well-being.
Banks provided considerable credit in the aftermath of the September 11 attacks, when financial flows were slowed by operational problems. To be sure, banks were able to provide this credit in part because of the huge injection of liquidity provided by the Federal Reserve. But that is a key role for banks in a crisis: to obtain funds--through the discount window or from open market operations, if necessary--and to channel them to those needing funds, based on an assessment of their creditworthiness. Banks' access to the discount window and the payments system, as well as their ongoing relationships with customers and their credit-evaluation skills, allow them to play this role. During a crisis, those banks that play critical roles in the payments system are especially important. As a result, these banks are expected to be very resilient. Though banks now have a smaller role in transmitting monetary policy, they still help to transmit policy actions by arbitraging between the federal funds market and other money markets.

US: DUAL BANKING REGULATION

In the US, banks may be chartered by the states or by the Office of the Comptroller of the Currency (OCC). Banks chartered by the OCC are known as national banks. The OCC also regulates federal branches and agencies of foreign banks. This separation of functions between the states and the federal authorities is sometimes problematic as states may want to impose rules on banks carrying on business on their territory and the federal authorities may be sensitive about issues of pre-emption in relation to national banks. The following **excerpt from a speech[17] 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

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

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

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

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

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

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

Currency:[18]

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

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

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

[18] http://www.occ.treas.gov/ftp/release/2002-80a.txt .

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.[19] In addition states often have parity statutes which allow state banks to have many of the benefits they would derive from a national charter.

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

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

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

This question may matter. States sometimes try to regulate what banks do within their territory. In particular, states enacted statutes to control predatory lending.[20] Predatory lenders impose

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

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

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.[21] The statutes tend to be drafted to cover lending within the state rather than lending by state chartered banks. This makes some sense if borrowers cannot easily distinguish between state chartered and national banks and therefore cannot easily work out what rules would regulate predatory lending. However, national banks objected to being subjected to these state laws on the basis that they are pre-empted. A major concern underlying the objection was the impact of state predatory lending laws on securitizations. Rating agencies 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).[22] Rating agencies and lenders suggested 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 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

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

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

after the loan was closed, sold or even paid off.[23]

In January 2004 the OCC issued two rules: one on Bank Activities and Operations; Real Estate Lending and Appraisals[24] and the other on Bank Activities and Operations.[25] These rules attempt to delineate when state rules may impact national banks and when they may not.

In **Watters v. Wachovia Bank**[26] the Supreme Court held that the National Banking Act operated to pre-empt state rules with respect to a subsidiary of a national bank:

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

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

[24] 69 Fed. Reg. 1904 (Jan 13, 2004).

[25] 69 Fed. Reg 1895 (Jan 13, 2004).

[26] 550 U.S. 1 (2007).

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

Nearly 200 years ago, in McCulloch v. Maryland this Court held.federal law supreme over state law with respect to national banking. Though the bank at issue in McCulloch was short-lived, a federal banking system reemerged in the Civil War era. In 1864, Congress enacted the NBA, establishing the system of national banking still in place today. The Act vested in nationally chartered banks enumerated powers and "all such incidental powers as shall be necessary to carry on the business of banking." To prevent inconsistent or intrusive state regulation from impairing the national system, Congress provided: "No national bank shall be subject to any visitorial powers except as authorized by Federal law . . . ."
In the years since the NBA's enactment, we have repeatedly made clear that .federal control shields national banking from unduly burdensome and duplicative state regulation...Federally chartered banks are subject to state laws of general application in their daily business to the extent such laws do not conflict with the letter or the general purposes of the NBA. For example, state usury laws govern the maximum rate of interest national banks can charge on loans, contracts made by national banks "are governed and construed by State laws," and national banks'"acquisition and transfer of property [are] based on State law,"..However, "the States can exercise no control over [national banks], nor in any wise affect their operation, except in so far as Congress may see proper to permit. Any thing beyond this is an abuse, because it is the usurpation of power which a single State cannot give."
We have "interpret[ed] grants of both enumerated and incidental 'powers' to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law." States are permitted to regulate the activities of national banks where doing so does not prevent or significantly interfere with the national bank's or the national bank regulator's exercise of its powers. But when state prescriptions significantly impair the exercise of authority, enumerated or incidental under the NBA, the State's regulations must give way.
The NBA authorizes national banks to engage in mortgage lending, subject to OCC regulation. The Act provides:
"Any national banking association may make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate, subject to 1828(o) of this title and such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order."
Beyond genuine dispute, state law may not significantly burden a national bank's own exercise of its real estate lending power, just as it may not curtail or hinder a national bank's efficient exercise of any other power, incidental or enumerated under the NBA. In particular, real estate lending, when conducted by a national bank, is immune from state visitorial control: The NBA specifically vests exclusive authority to examine and inspect in OCC..("No national bank shall be subject to any visitorial powers except as authorized by Federal law.").
Harmoniously, the Michigan provisions at issue exempt national banks from coverage. This is not simply a matter of the Michigan Legislature's grace. For, as the parties recognize, the NBA would have preemptive force, i.e., it would spare a national bank from state controls of the kind here involved. State laws that conditioned national banks' real estate lending on registration with the State, and subjected such lending to the State's investigative and enforcement machinery would surely interfere with the banks' federally authorized business: National banks would be subject to registration, inspection, and

enforcement regimes imposed not just by Michigan, but by all States in which the banks operate. Diverse and duplicative superintendence of national banks' engagement in the business of banking, we observed over a century ago, is precisely what the NBA was designed to prevent: "Th[e] legislation has in view the erection of a system extending throughout the country, and independent, so far as powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States." Congress did not intend, we explained, "to leave the field open for the States to attempt to promote the welfare and stability of national banks by direct legislation. . . . [C]onfusion would necessarily result from control possessed and exercised by two independent authorities."
Recognizing the burdens and undue duplication state controls could produce, Congress included in the NBA an express command: "No national bank shall be subject to any visitorial powers except as authorized by Federal law. . . ." "Visitation," we have explained "is the act of a superior or superintending officer, who visits a corporation to examine into its manner of conducting business, and enforce an observance of its laws and regulations." ..Michigan, therefore, cannot confer on its commissioner examination and enforcement authority over mortgage lending, or any other banking business done by national banks.
While conceding that Michigan's licensing, registration, and inspection requirements cannot be applied to national banks, ..Watters argues that the State's regulatory regime survives preemption with respect to national banks' operating subsidiaries. Because such subsidiaries are separately chartered under some State's law, Watters characterizes them simply as "affiliates" of national banks, and contends that even though they are subject to OCC's superintendence, they are also subject to multistate control. We disagree.
Since 1966, OCC has recognized the "incidental" authority of national banks .. to do business through operating subsidiaries. That authority is uncontested by Michigan's commissioner. ..OCC licenses and oversees national bank operating subsidiaries just as it does national banks.
In 1999, Congress defined and regulated "financial" subsidiaries; simultaneously, Congress distinguished those national bank affiliates from subsidiaries--typed "operating subsidiaries" by OCC--which may engage only in activities national banks may engage in directly, "subject to the same terms and conditions that govern the conduct of such activities by national banks." Gramm-Leach-Bliley Act (GLBA).. For supervisory purposes, OCC treats national banks and their operating subsidiaries as a single economic enterprise. OCC oversees both entities by reference to "business line," applying the same controls whether banking "activities are conducted directly or through an operating subsidiary."
As earlier noted, Watters does not contest the authority of national banks to do business through operating subsidiaries. Nor does she dispute OCC's authority to supervise and regulate operating subsidiaries in the same manner as national banks. Still, Watters seeks to impose state regulation on operating subsidiaries over and above regulation undertaken by OCC. But just as duplicative state examination, supervision, and regulation would significantly burden mortgage lending when engaged in by national banks, so too would those state controls interfere with that same activity when engaged in by an operating subsidiary.

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

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

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

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

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

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

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

...the OCC declined to exercise its perceived authority to occupy the field with regard to the real estate lending activities of National Banks. Instead, in the Rule, the OCC provides that "state laws that obstruct, impair, or condition a national bank's ability to fully exercise its federally authorized real estate lending powers do not apply to national banks." The Rule then lists examples of state laws that are and are not preempted by the Rule. Second, the Rule was silent on the issue of whether assignee liability provisions contained in state laws and regulations (including anti-predatory lending laws) apply to assignees of loans originated by National Banks..Finally, the Rule did not address the extent to which servicing restrictions in state anti-predatory lending laws could directly apply to purchasers or assignees of loans originated by National Banks.[27]

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?

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

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. [28]

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

[28] 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

the context of banking, which stated:[29]

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.

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

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

(2000/12/EC).[30]

In 2006 the Commission announced that it was taking enforcement action against France in relation to a French rule which prohibited interest bearing current accounts:[31]

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.

In 2008 France abolished the legal provisions that prohibited banks from paying interest on current accounts.[32]

The ECJ addressed these issues in a decision in 2004 in **Caixa Bank v France** that the Member States were prohibited under the EC treaty from restricting subsidiaries of banks established in other Member States from offering interest bearing "sight accounts" [33]:

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,

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

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

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

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

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

public and the granting of credits represent the basic activities of credit institutions...

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

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

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

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

21 It must be observed, however, that while the protection of consumers is among the overriding requirements that can justify restrictions on a fundamental freedom guaranteed by the EC Treaty, the prohibition at issue in the main proceedings, even supposing that it ultimately presents certain benefits for the consumer, constitutes a measure which goes beyond what is necessary to attain that objective.

22 Even supposing that removing the prohibition of paying remuneration on sight accounts necessarily entails for consumers an increase in the cost of basic banking services or a charge for cheques, the possibility might be envisaged inter alia of allowing consumers to choose between an unremunerated sight account with certain basic banking services remaining free of charge and a remunerated sight account with the credit institution being able to make charges for banking services previously provided free, such as the issuing of cheques.

23 As regards, next, the French authorities' concern to encourage long-term saving, it must be observed that, while the prohibition of remuneration on sight accounts is indeed suitable for encouraging medium and long-term saving, it nevertheless remains a measure which goes beyond what is necessary to attain that objective.

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

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

CAPITAL ADEQUACY (INTRODUCTION)

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

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

Risk Weightings:
0% :(a) Cash; (b) Claims on central governments and central banks denominated in national currency and funded in that currency; (c) Other claims on OECD[34] central governments and central banks; (d) Claims collateralised by cash of OECD central-government securities or guaranteed by OECD central governments
0, 10, 20 or 50% (at national discretion): (a) Claims on domestic public-sector entities, excluding central government, and loans guaranteed by or collateralised by securities issued by such entities;
20% :(a) Claims on multilateral development banks and claims guaranteed by, or collateralised by securities issued by such banks; (b) Claims on banks incorporated in the OECD and claims guaranteed by OECD incorporated banks; (c) Claims on securities firms incorporated in the OECD subject to comparable supervisory and regulatory arrangements, including in particular risk-based capital requirements, and claims guaranteed by these securities firms; (d) Claims on banks incorporated in countries outside the OECD with a residual maturity of up to one year and claims with a residual maturity of up to one year guaranteed by banks incorporated in countries outside the OECD; (e) Claims on non-domestic OECD public-sector entities, excluding central government, and claims guaranteed by or collateralised by securities issued by such entities; (f) Cash items in process of collection
50% :(a) Loans fully secured by mortgage on residential property that is or will be occupied by

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

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

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

Weaknesses of the Accord:
- Risk weightings do not encourage banks to be careful about credit allocation, and are very rough
- The current rules favour OECD entities
- Valuation issues : "Minimum capital requirements for banks are of little use if the accounting conventions used to value banks' assets are flawed."[35]
- The rules may limit the amount of credit available, or at least affect who has access to credit
- The 1988 Accord only deals with credit risk (market risk has subsequently been addressed).
- Should financial innovation be driven by regulation rather than by customers' needs?
- There are doubts as to whether the Accord effectively harmonizes prudential rules because of the scope for interpretation of the requirements and possibilities of difference in application.

Basel II[36]
Basel II focuses on:
1. minimum capital requirements, which seek to refine the measurement framework set out in the 1988 Accord
2 supervisory review of an institution's capital adequacy and internal assessment process
3 market discipline through effective disclosure to encourage safe and sound banking practices

[35] Andrew Crockett

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

1. Minimum Capital Requirements

Risk Weighting

A. Standardised Approach

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

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

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

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

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

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

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

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

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

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

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

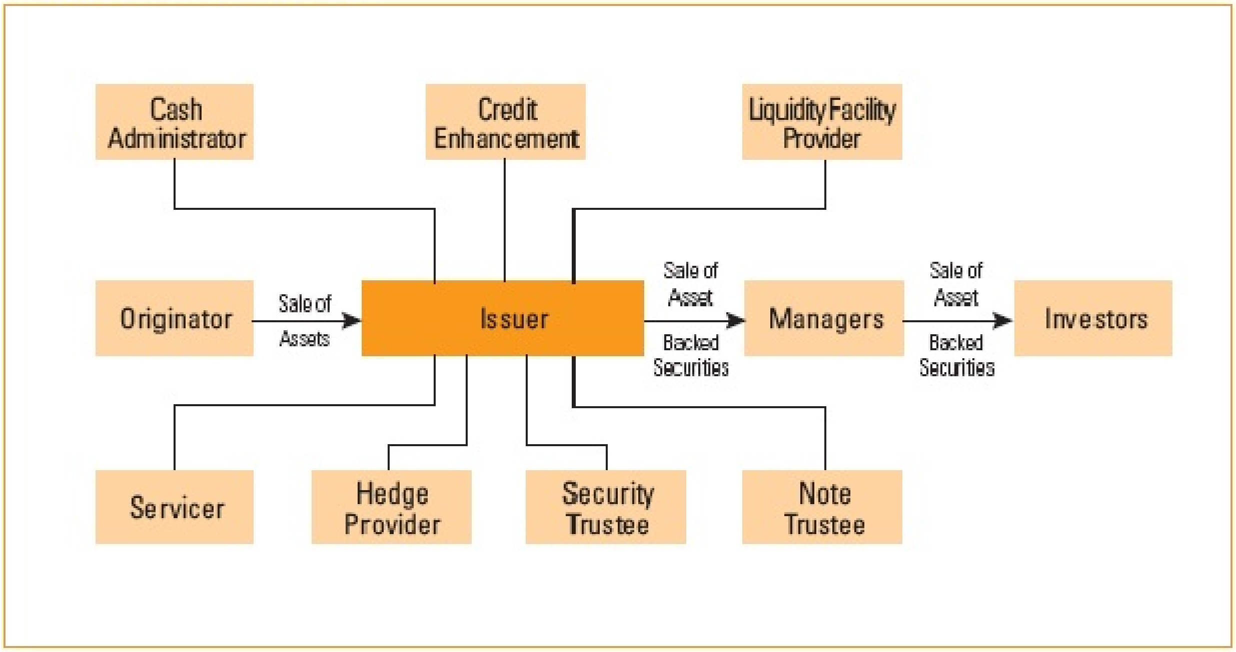
3 Market Discipline

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

During 2009 the Basel Committee proposed changes to address issues with respect to capital requirements and securitization, flaws in risk management practices and disclosure to enhance market discipline.

Typical Securitisation Structures

True Sale Securitisation



From: IFC, Securitization: Key Legal and Regulatory Issues, (2004)[37]

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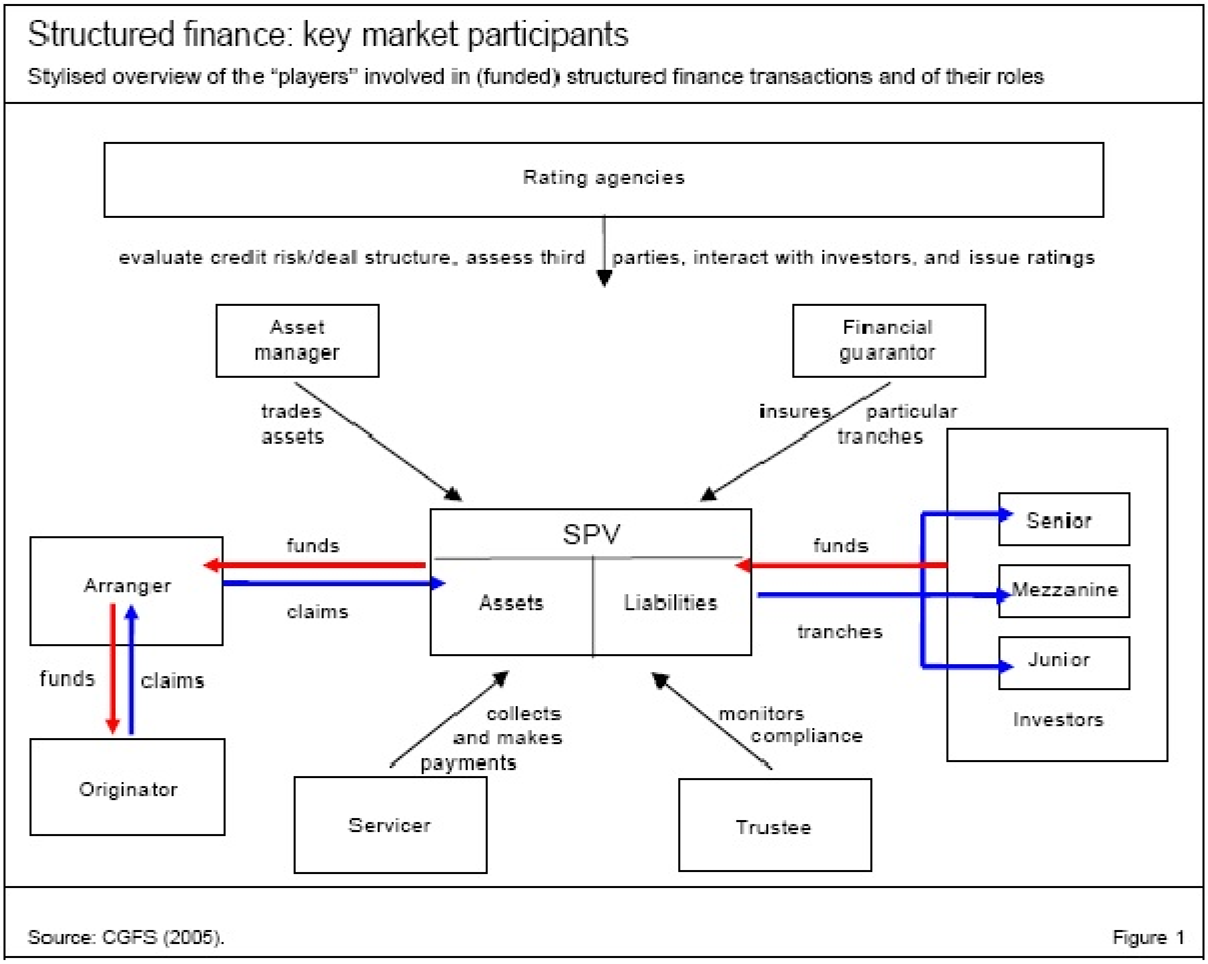
[37] http://www.ifc.org/ifcext/eca.nsf/AttachmentsByTitle/Securitization1A%2B9-04/$FILE/Securitization1A%2B9-04.pdf



From: Ingo Fender, Janet Mitchell, Structured Finance: Complexity, Risk and the Use of Ratings, BIS Quarterly Review, June 2005[38]

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