

# INTERNATIONAL FINANCE SPRING 2013

## ISSUES IN CROSS BORDER FINANCIAL REGULATION

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FINANCIAL REGULATION, TRUST, AND CONFIDENCE IN THE FINANCIAL MARKETS. . . .	<u>1</u>
INSTITUTIONS OF TRANSNATIONAL FINANCIAL REGULATION. . . . .	<u>7</u>
excerpt from a paper discussing some of the issues that arise in multi-level systems. . .	<u>14</u>
FSB Framework for Strengthening Adherence to International Standards. . . . .	<u>26</u>
OBJECTIVES OF BANKING REGULATION AND SECURITIES REGULATION.. . . . .	<u>29</u>
IOSCO's Objectives and Principles of Securities Regulation.. . . . .	<u>35</u>
Basel Committee's Core Principles for Effective Banking Supervision. . . . .	<u>37</u>
Joint Report on Differences in Accounting and Capital Standards Among the Federal Banking Agencies. . . . .	<u>43</u>
12 USC § 3105. . . . .	<u>44</u>
Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies. . . . .	<u>49</u>
ARE BANKS DIFFERENT FROM OTHER FINANCIAL INSTITUTIONS ?. . . . .	<u>57</u>
US: DUAL BANKING REGULATION. . . . .	<u>58</u>
Mark W. Olson . . . . .	<u>58</u>
John Hawke. . . . .	<u>59</u>
Watters v. Wachovia Bank.. . . . .	<u>66</u>
Cuomo v. Clearing House Association.. . . . .	<u>71</u>
Julie Williams . . . . .	<u>76</u>
CAPITAL ADEQUACY (AN INTRODUCTION).. . . . .	<u>77</u>

### FINANCIAL REGULATION, TRUST, AND CONFIDENCE IN THE FINANCIAL MARKETS

Countries regulate domestic financial activity to protect investors, depositors, and other categories of consumer in order to preserve the domestic financial markets. The essential functions of financial markets are relatively simple: they enable businesses to raise money, and investors to obtain a return on capital they do not need for current consumption. Both of these functions are crucial to the functioning of capitalist economies. Businesses need to ensure supplies of capital in order to grow, and investors need to be able to provide for their future

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needs. The functions are also linked, as, ultimately, the money that businesses use comes from investors. If investors do not feel safe in committing their money to the businesses which need the money, they will refuse to invest, perhaps hiding the money under their mattresses. Moreover, if financial firms fail their failures may be transmitted to other financial firms through the payments system. Such failures harm confidence. Thus, governments are convinced of the need to act to maintain investor/depositor confidence in the financial markets. Over the period since the summer of 2007 we have seen what happens when market participants lose confidence in the financial markets. In this period of turmoil, some of the regulatory mechanisms which had been designed to maintain confidence turned out to be ineffective.<sup>2</sup> Regulators have been focusing on a range of safety and soundness issues with respect to banks, especially relating to liquidity and risk concentrations, and on issues relating to complex financial instruments (and the failure of credit rating agencies to rate such instruments accurately). The current problems illustrate the interconnection of the financial markets in different parts of the world. **Már Gudmundsson** said in a speech in September 2008:<sup>3</sup>

The current global financial crisis has now lasted more than a year, with no immediate end in sight. The crisis was triggered by increasing defaults on subprime mortgages and the turn of the housing cycle in the United States. Subsequently, the credit ratings of structured products, wholly or partly based on these mortgages, were significantly downgraded, raising uncertainty about the valuation of such products.

It was at this point that the banks at the centre of the financial system were hit much more speedily than most had envisaged before the crisis. Thus the drying-up of the market for asset-backed commercial paper created pressure on banks' funding liquidity. The reason was that the banks needed, for legal or reputational reasons, to provide their special purpose vehicles with liquidity or to bring them back onto their balance sheets. Thus, the banks needed to make more use of their own funding liquidity at the same time as their future liquidity needs were becoming both bigger and more uncertain. On top of this, they were becoming more uncertain about the creditworthiness of other banks, as they did not know where the exposure to the toxic subprime and structured product stuff was, or which banks might face problems because they would be forced into a distressed sale of assets due to a lack of funding liquidity. The result was a generalised hoarding of funding liquidity, which might have been rational from the standpoint of individual banks but was disastrous for the system as a whole.

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<sup>2</sup> Deposit insurance schemes are an example of this. Deposit insurance schemes are supposed to prevent bank runs by persuading depositors that their money is safe. But depositors' fears that they might have to wait for their money prompted legislators to rethink deposit insurance schemes. See Sebastian Schich, *Financial Turbulence: Some Lessons Regarding Deposit Insurance*, Financial Market Trends No. 94, 55 (Volume 2008/1) available at <http://www.oecd.org/dataoecd/32/54/41420525.pdf>

<sup>3</sup> See <http://www.bis.org/speeches/sp081119.htm>. At the time he was Deputy Head of the Monetary and Economic Department of the BIS (Bank for International Settlements) and he became Governor of the Central Bank of Iceland in 2009.

This hoarding of funding liquidity made the crisis come to the fore in the drying-up of market liquidity in interbank money markets in the United States and in Europe on 9 August last year. This in turn prompted central banks in these regions to inject massive amounts of liquidity in order to stop money market interest rates from rising far above targeted levels.

We now know that this was only the beginning. What at first seemed mostly to be a US problem is now increasingly a global problem. What at first seemed to be valuation problems in specific segments of financial markets have turned into a broader-based downturn in asset prices. What at first seemed to be a liquidity problem has turned into major losses and writedowns of bank capital.

We are currently in a phase of this crisis where significant parts of the financial system in advanced economies are being forced to reduce their assets relative to capital, that is, to reduce what is called leverage. The reason is that the current level of leverage of many financial institutions implies a higher level of risk than they can manage in this environment of higher funding costs, increased volatility of most financial prices and more uncertainty. The deleveraging can take place through the raising of additional capital, which is currently becoming more difficult, or the disposal of assets and use of the proceeds to repay debt. However, a deleveraging of the whole financial sector, as distinct from individual institutions in normal market conditions, is a painful process involving asset price deflation and a lack of market liquidity.

The impairment of the wholesale money market along with higher funding costs and shorter available maturities has made many business models untenable. Those relying on short-term funding in wholesale money markets have been particularly vulnerable. This was the undoing of Northern Rock and contributed to the downfall of investment banks. One result of the decline of wholesale funding has been a significantly higher degree of competition for deposits, particularly in Europe.

The metamorphosis of the crisis from its initial stages to now is easier to understand when we realise that it had deeper causes than the faults in US subprime loan origination and the associated securitisation process. The crisis was preceded by a period of low real interest rates and easy access to credit, which fuelled risk-taking and debt accumulation. In the United States, it was the case both for households and for the financial sector itself. However, although the increased indebtedness of the US household sector was plain for everybody to see, the increased leverage of the financial sector was somewhat hidden. One reason was that the leverage was partly accumulating in what is now being called the shadow banking system. Another reason was that the focus on risk metrics like value-at-risk and the use of short time series as inputs allowed the low recent volatility of asset prices to mask the increase in leverage.

In the United States, easy credit conditions were made even more so by global current account imbalances and the willingness of foreign governments to finance the US current account deficit. Easy monetary policy in the aftermath of the bursting of the tech stock bubble in 2001 might also have contributed at the margin, although easy credit preceded it.

Last but not least, financial innovation contributed to debt accumulation. In particular, the originate-to-distribute model made it possible to originate loans - especially mortgages - to households, securitise them in large quantities, slice and dice them into differently rated tranches, and then sell them

all over the world to both risk-averse and risk-seeking investors. The effect was that loan origination was less constrained by the balance sheet capacity of banks.

One result of this setup was that risk was apparently spread away from the institutions that are critical for the overall functioning and stability of the financial system, which should be good from the standpoint of financial stability. However, as it turned out, the distribution was less than met the eye, as the asset-backed securities were often held by special purpose vehicles closely associated with the banks originating them. Some commentators have for this reason called the arrangement "originate and pretend to distribute". Furthermore, as the value of structured products was potentially unstable and would become very uncertain at the first sign of stress and illiquidity in financial markets, what was distributed was not only risk, but also uncertainty and fear.

The upshot of all of this was the underpricing of risk. This underpricing was widely recognised in the central banking community, and by others, and was expected to result in significant repricing, which would in all probability be associated with lower asset values and a downturn in the credit cycle. What nobody knew, of course, was the timing of this repricing; nor did anyone anticipate the speed and ferocity of the change or the degree to which it would, in the first round, affect the core of the financial system.

The "shadow banking system" Gudmundsson refers to involves non-bank institutions which behave like banks, borrowing short (issuing commercial paper, which is short term debt) and lending long. These non-bank entities were not regulated in the same way that banks are, and have not been part of deposit insurance systems, nor have they had access to lender of last resort facilities available to banks, although AIG (which was linked to the banking system through its involvement in credit default swaps) was bailed out by the US Government in 2008. The **Congressional Oversight Panel** criticized this bailout:

At its peak, American International Group (AIG) was one of the largest and most successful companies in the world, boasting a AAA credit rating, over \$1 trillion in assets, and 76 million customers in more than 130 countries. Yet the sophistication of AIG's operations was not matched by an equally sophisticated risk-management structure. This poor management structure, combined with a lack of regulatory oversight, led AIG to accumulate staggering amounts of risk, especially in its Financial Products subsidiary, AIG Financial Products (AIGFP). Among its other operations, AIGFP sold credit default swaps (CDSs), instruments that would pay off if certain financial securities, particularly those made up of subprime mortgages, defaulted. So long as the mortgage market remained sound and AIG's credit rating remained stellar, these instruments did not threaten the company's financial stability.

The financial crisis, however, fundamentally changed the equation on Wall Street. As subprime mortgages began to default, the complex securities based on those loans threatened to topple both AIG and other long-established institutions. During the summer of 2008, AIG faced increasing demands from their CDS customers for cash security . known as collateral calls totaling tens of billions of dollars. These

costs put AIG's credit rating under pressure, which in turn led to even greater collateral calls, creating even greater pressure on AIG's credit.

By early September, the problems at AIG had reached a crisis point. A sinkhole had opened up beneath the firm, and it lacked the liquidity to meet collateral demands from its customers. In only a matter of months AIG's worldwide empire had collapsed, brought down by the company's insatiable appetite for risk and blindness to its own liabilities.

AIG sought more capital in a desperate attempt to avoid bankruptcy. When the company could not arrange its own funding, Federal Reserve Bank of New York President Timothy Geithner, who is now Secretary of the Treasury, told AIG that the government would attempt to orchestrate a privately funded solution in coordination with JPMorgan Chase and Goldman Sachs. A day later, on September 16, 2008, FRBNY abandoned its effort at a private solution and rescued AIG with an \$85 billion, taxpayer-backed Revolving Credit Facility (RCF). These funds would later be supplemented by \$49.1 billion from Treasury under the Troubled Asset Relief Program (TARP), as well as additional funds from the Federal Reserve, with \$133.3 billion outstanding in total. The total government assistance reached \$182 billion....

The government failed to exhaust all options before committing \$85 billion in taxpayer funds. In previous rescue efforts, the federal government had placed a high priority on avoiding direct taxpayer liability for the rescue of private businesses. For example, in 1998, the Federal Reserve pressed private parties to prevent the collapse of Long-Term Capital Management, but no government money was used. In the spring of 2008, the Federal Reserve arranged for the sale of Bear Stearns to JPMorgan Chase. Although the sale was backed by \$28.2 billion of federal loans, much of the risk was borne by private parties.

With AIG, the Federal Reserve and Treasury broke new ground. They put U.S. taxpayers on the line for the full cost and the full risk of rescuing a failing company.

During the Panel's meetings, the Federal Reserve and Treasury repeatedly stated that they faced a "binary choice": either allow AIG to fail or rescue the entire institution, including payment in full to all of its business partners. The government argues that AIG's failure would have resulted in chaos, so that a wholesale rescue was the only viable choice. The Panel rejects this all-or-nothing reasoning. The government had additional options at its disposal leading into the crisis, although those options narrowed sharply in the final hours before it committed \$85 billion in taxpayer dollars.

For example, the federal government could have acted earlier and more aggressively to secure a private rescue of AIG. Government officials, fully aware that both Lehman Brothers and AIG were on the verge of collapse, prioritized crafting a rescue for Lehman while they left AIG to attempt to arrange its own funding. By the time the Federal Reserve Bank reversed that approach, leaving Lehman to collapse into bankruptcy without help and concluding that AIG posed a greater threat to financial stability, time to explore other options was short. The government then put the efforts to organize a private AIG rescue in the hands of only two banks, JPMorgan Chase and Goldman Sachs, institutions that had severe conflicts of interest as they would have been among the largest beneficiaries of a taxpayer rescue.

When that effort failed, the Federal Reserve decided not to press major lenders to participate in a private deal or to propose a rescue that combined public and private funds. As Secretary Geithner later

explained to the Panel it would have been irresponsible and inappropriate in his view for a central banker to press private parties to participate in deals to which the parties were not otherwise attracted. Nor did the government offer to extend credit to AIG only on the condition that AIG negotiate discounts with its financial counterparties. Secretary Geithner later testified that he believed that payment in full to all AIG counterparties was necessary to stop a panic. In short, the government chose not to exercise its substantial negotiating leverage to protect taxpayers or to maintain basic market discipline.

There is no doubt that orchestrating a private rescue in whole or in part would have been a difficult – perhaps impossible – task, and the effort might have met great resistance from other financial institutions that would have been called on to participate. But if the effort had succeeded, the impact on market confidence would have been extraordinary, and the savings to taxpayers would have been immense. Asking for shared sacrifice among AIG's counterparties might also have provoked substantial opposition from Wall Street. Nonetheless, more aggressive efforts to protect taxpayers and to maintain market discipline, even if such efforts had failed, might have increased the government's credibility and persuaded the public that the extraordinary actions that followed were undertaken to protect them.

The rescue of AIG distorted the marketplace by transforming highly risky derivative bets into fully guaranteed payment obligations. In the ordinary course of business, the costs of AIG's inability to meet its derivative obligations would have been borne entirely by AIG's shareholders and creditors under the well-established rules of bankruptcy. But rather than sharing the pain among AIG's creditors, an outcome that would have maintained the market discipline associated with credit risks, the government instead shifted those costs in full onto taxpayers out of a belief that demanding sacrifice from creditors would have destabilized the markets. The result was that the government backed up the entire derivatives market, as if these trades deserved the same taxpayer backstop as savings deposits and checking accounts.

One consequence of this approach was that every counterparty received exactly the same deal: a complete rescue at taxpayer expense. Among the beneficiaries of this rescue were parties whom taxpayers might have been willing to support, such as pension funds for retired workers and individual insurance policy holders. But the across-the-board rescue also benefitted far less sympathetic players, such as sophisticated investors who had profited handsomely from playing a risky game and who had no reason to expect that they would be paid in full in the event of AIG's failure. Other beneficiaries included foreign banks that were dependent on contracts with AIG to maintain required regulatory capital reserves. Some of those same banks were also counterparties to other AIG CDSs.

Throughout its rescue of AIG, the government failed to address perceived conflicts of interest. People from the same small group of law firms, investment banks, and regulators appeared in the AIG saga in many roles, sometimes representing conflicting interests. The lawyers who represented banks trying to put together a rescue package for AIG became the lawyers to the Federal Reserve, shifting sides within a matter of minutes. Those same banks appeared first as advisors, then potential rescuers, then as counterparties to several different kinds of agreements with AIG, and ultimately as the direct and indirect beneficiaries of the government rescue. The composition of this tightly intertwined group meant that everyone involved in AIG's rescue had the perspective of either a banker or a banking regulator.

These entanglements created the perception that the government was quietly helping banking insiders at the expense of accountability and transparency....

The government's actions in rescuing AIG continue to have a poisonous effect on the marketplace. By providing a complete rescue that called for no shared sacrifice among AIG's creditors, the Federal Reserve and Treasury fundamentally changed the relationship between the government and the country's most sophisticated financial players. Today, AIG enjoys a five-level improvement in its credit rating based solely on its access to government funding on generous terms. Even more significantly, markets have interpreted the government's willingness to rescue AIG as a sign of a broader implicit guarantee of "too big to fail" firms. That is, the AIG rescue demonstrated that Treasury and the Federal Reserve would commit taxpayers to pay any price and bear any burden to prevent the collapse of America's largest financial institutions, and to assure repayment to the creditors doing business with them. So long as this remains the case, the worst effects of AIG's rescue on the marketplace will linger...

Through a series of actions, including the rescue of AIG, the government succeeded in averting a financial collapse, and nothing in this report takes away from that accomplishment. But this victory came at an enormous cost. Billions of taxpayer dollars were put at risk, a marketplace was forever changed, and the confidence of the American people was badly shaken.<sup>4</sup>

## **INSTITUTIONS OF TRANSNATIONAL FINANCIAL REGULATION**

Rules of financial regulation, and the rules of private law which help to constitute cross-border transactions, are artefacts of domestic legal systems. However, activity which crosses territorial boundaries raises questions about what law applies, and how law applies to those transactions. Domestic regulators, legislatures and courts are actors in transnational financial law because of cross-border transactions.

Parties to transnational transactions can choose which rules of contract law apply to their transactions, subject to the risk that in a particular jurisdiction (with which the transaction is connected in some way) some rules of contract law or non-contract law will be treated as being mandatory and not able to be contracted around (for example, fiduciary duties, rules of securities regulation, and anti-trust law). Cross-border transactions raise issues of choice of law and jurisdiction, and domestic courts are involved in applying the relevant rules. Some cross-border transactions include arbitration provisions. Parties to transnational transactions can avoid the application of certain legal rules by avoiding connections with certain jurisdictions.

Transnational financial regulation is accomplished in a multi-level and networked

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<sup>4</sup> Congressional Oversight Panel, The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy, 7-10 (Jun. 10, 2010). The Congressional Oversight Panel Archive is available at <http://cybercemetery.unt.edu/archive/cop/20110401223205/http://www.cop.senate.gov/>.

environment by means of mutual recognition of regulatory schemes,<sup>5</sup> accommodations to foreign firms which are subjected to domestic regulation by the host state, and agreements by networks of domestic regulators on harmonized standards.<sup>6</sup> Financial regulators based in different jurisdictions work together to regulate transnational financial activity, through Memoranda of Understanding (MOUs), through transnational standard-setting organizations, and in the context of supervision and enforcement.

At the supranational level there are international organizations which have an interest in financial markets and financial regulation. Different organizations have different mandates and structures. Some inter-governmental organizations, such as the Basel Committee on Banking Supervision, IOSCO (International Organisation of Securities Commissions), and the IAIS (International Association of Insurance Supervisors) are essentially collaborative, technocratic organizations with the power to develop non-binding recommendations, principles and standards. The Basle Committee on Banking Supervision (BCBS) describes itself as follows:

The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision.

The Committee's members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United

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<sup>5</sup> See, e.g., Commission Implementing Decision on the Recognition of the Legal and Supervisory Framework of Canada as Equivalent to the Requirements of Regulation (Ec) No 1060/2009 of the European Parliament and of the Council on Credit Rating Agencies, O.J., L 278/17 (Oct. 12, 2012); Commission Implementing Decision on the Recognition of the Legal and Supervisory Framework of the United States of America as Equivalent to the Requirements of Regulation (Ec) No 1060/2009 of the European Parliament and of the Council on Credit Rating Agencies, O.J., L 274/32 (Oct. 9, 2012); Commission Implementing Decision on the Recognition of the Legal and Supervisory Framework of Australia as Equivalent to the Requirements of Regulation (Ec) No 1060/2009 of the European Parliament and of the Council on Credit Rating Agencies, O.J., L 274/30 (Oct. 9, 2012); European Securities and Markets Authority, Technical Advice on CRA Regulatory Equivalence - US, Canada and Australia: Final Report (Apr. 18, 2012) at [http://www.esma.europa.eu/system/files/2012\\_-259\\_0.pdf](http://www.esma.europa.eu/system/files/2012_-259_0.pdf).

<sup>6</sup> See, e.g., EU-US Coalition on Financial Regulation, Mutual Recognition, Exemptive Relief and "Targeted" Rules' Standardisation: The Basis for Regulatory Modernisation, 7-8 (Mar. 2008) at <http://www.sifma.org/uploadedfiles/newsroom/2008/us-eucoalition-fin-regualtion-reportmar08.pdf>.



Kingdom and the United States. The present Chairman of the Committee is Mr Stefan Ingves, Governor of Sveriges Riksbank.

The Committee encourages contacts and cooperation among its members and other banking supervisory authorities. It circulates to supervisors throughout the world both published and unpublished papers providing guidance on banking supervisory matters. Contacts have been further strengthened by an International Conference of Banking Supervisors (ICBS) which takes place every two years.

The Committee's Secretariat is located at the Bank for International Settlements in Basel, Switzerland, and is staffed mainly by professional supervisors on temporary secondment from member institutions. In addition to undertaking the secretarial work for the Committee and its many expert sub-committees, it stands ready to give advice to supervisory authorities in all countries. Mr Wayne Byres is the Secretary General of the Basel Committee.<sup>7</sup>

In contrast to intergovernmental/inter-regulator organizations, the European Union has supranational institutions which function like a legislature, creating rules which are binding on its Member States and, in some circumstances, on people and businesses within those Member States.<sup>8</sup> Traditionally the EU has legislated for financial regulation using directives which require implementation in the Member States and thus function as instructions to the Member States to introduce rules which give effect to the provisions of the directives. More recently the EU has begun to legislate using regulations.<sup>9</sup> Regulations take effect directly within the legal systems of the Member States without any need for, or possibility of, implementing action by the Member States (like a federal statute). In response to the financial crisis the EU established a European Systemic Risk Board and new supervisory authorities (which were basically a reworking of existing institutions), and is planning to set up a European Banking Union for the eurozone (and other EU Member States which wish to join).

The IMF is a treaty-based international organization which was founded in 1944 to

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<sup>7</sup> <http://www.bis.org/bcbs/about.htm>

<sup>8</sup> The EU with its complex institutional structures has a closer resemblance to a federal government than other supranational standard-setters, and has focused greater attention on issues of governance and consultation. See, e.g., EU Commission, White Paper on European Governance, COM(2001) 428 final (Jul. 25, 2001); EU Commission, Communication from the Commission, Towards a reinforced culture of consultation and dialogue - General principles and minimum standards for consultation of interested parties by the Commission, 10, COM (2002) 704 final (Dec. 11, 2002).

<sup>9</sup> See, e.g., Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, OJ No. L 302/ 1 (Nov. 17, 2009) at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0001:0031:EN:PDF>. In 2012 the EU Commission recognised the legal and supervisory frameworks of the US, Canada and Australia as equivalent to the requirements of Regulation (EC) No 1060/2009 of the European Parliament and of the Council on credit rating agencies. See *supra* note [5](#).

govern the international monetary system to assure exchange rate stability and encourage IMF members to do away with exchange restrictions.<sup>10</sup> The IMF lends money to its member countries when they have needs for funding they are not able to meet in the financial markets, and recent events have increased demand for funds from the IMF. The IMF has funds available for crisis lending: Iceland benefitted from this facility.<sup>11</sup> As part of its lending programs, the IMF examines the economies of the countries to which it lends, including their bank regulatory systems.<sup>12</sup> The IMF's interest in monitoring the financial soundness of its members, especially of its borrowers, gives it an interest in regulation as a mechanism for promoting financial stability. The IMF has been criticized with respect to the requirements it imposes on borrowing countries. For example, commentators have argued that requiring privatization can be harmful: requiring privatization of the water industry tends to lead to charges for the provision of clean water which means that poor people do not have access to clean water.<sup>13</sup> The IMF has been working to address some of the concerns about its role by emphasizing transparency as an accountability mechanism.<sup>14</sup>

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<sup>10</sup> You can find the Articles of Agreement of the International Monetary Fund at <http://www.imf.org/external/pubs/ft/aa/index.htm> .

<sup>11</sup> See, e.g., IMF, IMF Completes First Review Under Stand-By Arrangement with Iceland, Extends Arrangement, and Approves US\$167.5 Million Disbursement, Press Release No. 09/375 (Oct. 28, 2009) at <http://www.imf.org/external/np/sec/pr/2009/pr09375.htm> ; IMF, Iceland: 2012 Article IV Consultation and First Postprogram Monitoring Discussion, IMF Country Report No. 12/89 (April 2012) at <http://www.imf.org/external/pubs/ft/scr/2012/cr1289.pdf> .

<sup>12</sup> Consider the comments of Poul Thomsen, at the time the IMF's mission chief for Iceland: "Iceland allowed a very oversized banking system to develop—a banking system that significantly outstripped the authorities' ability to act as a lender of last resort when the system ran into trouble. Only a few years ago, Iceland had a banking system that was the normal size. But after the privatization of the banking sector was completed in 2003, the banks increased their assets from being worth slightly more than 100 percent of GDP to being worth close to 1,000 percent of GDP. When confidence problems intensified this fall, Iceland was one of the first victims because the market realized that the banking system was far too big relative to the size of the economy. As investors started to pull out, it quickly spilled over into trouble for the Icelandic króna. Within a week the three banks collapsed, the króna's value dropped by more than 70 percent, and the stock market lost more than 80 percent of its value. For a small economy that is totally dependent on imports, this was a crisis of huge proportions." Camilla Andersen, Iceland Gets Help to Recover From Historic Crisis, IMF Survey Online (Dec. 2, 2008) available at <http://www.imf.org/external/pubs/ft/survey/so/2008/int111908a.htm> .

<sup>13</sup> See e.g., [http://www.jubileeusa.org/fileadmin/user\\_upload/Resources/Policy\\_Archive/Debt\\_and\\_Water\\_2004.pdf](http://www.jubileeusa.org/fileadmin/user_upload/Resources/Policy_Archive/Debt_and_Water_2004.pdf) .

<sup>14</sup> See, e.g., IMF, Consultation on the 2013 Review of the IMF's Transparency Policy at <http://www.imf.org/external/np/exr/consult/2013/transpol/index.htm> ; IMF, Transparency is Key to Accountability (Jan. 11, 2010) at <http://www.imf.org/external/np/exr/cs/news/2010/cso110.htm> .

Ten years before the global financial crisis, the Asian financial crisis<sup>15</sup> led to the development of the Financial Stability Forum (FSF), which was established in 1999. The FSF was designed to bring together representatives of national central banks, supervisory authorities and treasury departments, international financial institutions (e.g. the IMF and the World Bank), international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank. In 2009 the FSF was reborn as the Financial Stability Board:<sup>16</sup>

In November 2008, the Leaders of the G20 countries called for a larger membership of the FSF. A broad consensus emerged in the following months towards placing the FSF on stronger institutional ground with an expanded membership - to strengthen its effectiveness as a mechanism for national authorities, standard setting bodies and international financial institutions to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability. As announced in the G20 Leaders Summit of April 2009, the expanded FSF was re-established as the Financial Stability Board (FSB) with a broadened mandate to promote financial stability.<sup>17</sup>

In April 2009 the **G20**<sup>18</sup> issued a **Declaration on Strengthening the International Financial System** which stated:

We, the Leaders of the G20, have taken, and will continue to take, action to strengthen regulation and supervision in line with the commitments we made in Washington to reform the regulation of the financial sector. Our principles are strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets and reinforcing international cooperation.... In particular, we have

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<sup>15</sup> See, e.g., IMF, *Recovery from the Asian Crisis and the Role of the IMF* (Jun. 2000) at <http://www.imf.org/external/np/exr/ib/2000/062300.htm> ("The crises that began in Thailand with a series of speculative attacks on the baht unfolded after several decades of outstanding economic performance in Asia. Although the circumstances varied among the countries concerned, the difficulties stemmed primarily from a combination of macroeconomic imbalances (even though government budgets were broadly in balance and inflation rates were modest), external developments, and weakness in financial and corporate systems. The external imbalances were a reflection both of strong private capital inflows and of high domestic private investment rates, and were exacerbated, prior to the crisis, by appreciation of the U.S. dollar to which the currencies of the countries concerned were formally or informally pegged.")

<sup>16</sup> See <http://www.financialstabilityboard.org/> .

<sup>17</sup> <http://www.financialstabilityboard.org/about/history.htm> .

<sup>18</sup> The G20 comprises Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, Republic of Korea, Turkey, United Kingdom, United States of America and the EU. See [http://www.g20.org/about\\_what\\_is\\_g20.aspx](http://www.g20.org/about_what_is_g20.aspx) . Note that France, Germany, Italy and the UK are all members of the EU.

agreed the following major reforms.

We have agreed that the Financial Stability Forum should be expanded, given a broadened mandate to promote financial stability, and re-established with a stronger institutional basis and enhanced capacity as the Financial Stability Board (FSB).

The FSB will:

- assess vulnerabilities affecting the financial system, identify and oversee action needed to address them;
- promote co-ordination and information exchange among authorities responsible for financial stability;
- monitor and advise on market developments and their implications for regulatory policy;
- advise on and monitor best practice in meeting regulatory standards;
- undertake joint strategic reviews of the policy development work of the international Standard Setting Bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps;
- set guidelines for, and support the establishment, functioning of, and participation in, supervisory colleges, including through ongoing identification of the most systemically important cross-border firms;
- support contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and
- collaborate with the IMF to conduct Early Warning Exercises to identify and report to the IMFC and the G20 Finance Ministers and Central Bank Governors on the build up of macroeconomic and financial risks and the actions needed to address them.

Members of the FSB commit to pursue the maintenance of financial stability, enhance the openness and transparency of the financial sector, and implement international financial standards (including the 12 key International Standards and Codes), and agree to undergo periodic peer reviews, using among other evidence IMF / World Bank public Financial Sector Assessment Program reports. The FSB will elaborate and report on these commitments and the evaluation process.

We welcome the FSB's and IMF's commitment to intensify their collaboration, each complementing the other's role and mandate.<sup>19</sup>

The G20 also agreed to strengthen international co-operation, prudential regulation, to ensure systemically important institutions are subject to regulation, "to ensure compensation structures are consistent with firms' long-term goals and prudent risk taking," to deal with tax havens and territories which do not comply with money laundering controls, to improve accounting standards, and to regulate credit rating agencies more effectively.

The World Bank does not have a specific focus on financial regulation, although it has in recent years been interested in financial law and corporate governance as aspects of

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<sup>19</sup> G20 statements are available from <http://www.g20.org/documents/>.

governance seen as crucial to economic development.<sup>20</sup> A 2008 working paper states:

The process of globalization and financial development has been prone to crises. Over the long run, financial development is expected to support economic growth and poverty reduction. But, along the way, even relatively mature financial systems are vulnerable to systemic banking crises, cycles of booms and busts, and financial volatility. This appears to be partly intrinsic and partly due to policy mistakes. It arises as banks expand and capital markets generate new financial products. This entails new, unfamiliar, risks for financial intermediaries and regulators. Furthermore, as countries become more open to capital flows, crises are more easily transmitted across borders. The positive long-run relationship between financial development and growth coexists with a negative short-run relationship through financial fragility...

The most direct channel linking the developed world to the financial crisis emanating from the developed world in 2008 is through exposure to assets that are at the heart of the crisis, notably (though not only) the sub-prime mortgages. However, the more important channels for most developing countries will probably be indirect, notably through trade (via declining demand for developing- country exports or declining export process, including commodities), investment (as external finance contracts) and remittances (also stemming from the recession in the developed world).<sup>21</sup>

Other UN agencies have been involved in the negotiation of treaties which have an impact on financial transactions. For example, UNCITRAL, the United Nations Model Commission on International Trade Law, developed a Model Law on Cross-Border Insolvency,<sup>22</sup> and a Convention on the Assignment of Receivables in International Trade.<sup>23</sup> Non-UN international organizations may also be involved in developing harmonized standards relevant to financial transactions. Unidroit, the International Institute for the Unification of Private Law,<sup>24</sup> has developed a Convention on Substantive Rules for Intermediated Securities (securities held

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<sup>20</sup> See, e.g., Asli Demirgüç-Kunt & Ross Levine, Finance, Financial Sector Policies, and Long-run Growth, World Bank Policy Research Working Paper No. 4469 (Nov. 2008) available at [http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2008/01/07/000158349\\_20080107115116/Rendered/PDF/wps4469.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2008/01/07/000158349_20080107115116/Rendered/PDF/wps4469.pdf). See generally [www.worldbank.org/wbi/governance](http://www.worldbank.org/wbi/governance).

<sup>21</sup> The World Bank, Development Research Group, Lessons from World Bank Research on Financial Crises, 3-4, Policy Research Working Paper 4779 (Nov. 2008).

<sup>22</sup> See [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html). See also, e.g., <http://globalinsolvency.com/>.

<sup>23</sup> See [http://www.uncitral.org/uncitral/uncitral\\_texts/security/2001Convention\\_receivables.html](http://www.uncitral.org/uncitral/uncitral_texts/security/2001Convention_receivables.html).

<sup>24</sup> <http://www.unidroit.org/dynasite.cfm>

not directly by investors but indirectly through an intermediary such as a broker).<sup>25</sup> The OECD focuses on a range of issues relating to financial markets from general financial market trends<sup>26</sup> to corporate governance<sup>27</sup> and investor education.<sup>28</sup>

These interactions between domestic and supranational institutions can be seen as forming a system of multi-level governance or regulatory networks for financial market activity. Here is an excerpt from a paper discussing some of the issues that arise in multi-level systems:<sup>29</sup>

Over time, supranational standard-setters have begun to formalise their standard-setting processes, developing their practices for consulting on proposed standards, and even establishing consultation policies.<sup>30</sup> However, the different organizations approach consultation and the reporting of the results of consultation differently,<sup>31</sup> and there is, so far, no harmonised supranational administrative law.<sup>32</sup> Consultation processes which exclude groups which are affected by harmonised rules because of a lack of transparency,<sup>33</sup> or because the issues are framed in ways which make the views of affected groups seem irrelevant, lack legitimacy. Consumers and the organisations which represent their interests are

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<sup>25</sup> Convention on Substantive Rules for Intermediated Securities (Geneva, 2009) at <http://www.unidroit.org/english/conventions/2009intermediatedsecurities/main.htm> .

<sup>26</sup> [http://www.oecd.org/document/36/0,3343,en\\_2649\\_34849\\_1962020\\_1\\_1\\_1\\_37467,00.html](http://www.oecd.org/document/36/0,3343,en_2649_34849_1962020_1_1_1_37467,00.html)

<sup>27</sup> <http://www.oecd.org/daf/corporateaffairs/oecdprinciplesofcorporategovernance.htm> .

<sup>28</sup> See, e.g., OECD, Draft Good Practices on Financial Education and Awareness Relating to Credit (2008) available at <http://www.oecd.org/dataoecd/57/59/41804595.pdf> .

<sup>29</sup> Caroline Bradley, Financial Trade Associations and Multilevel Regulation. A version of this paper was published in Ramses Wessel, Andreas Follesdal & Jan Wouters eds., *Multilevel Regulation and the EU: The Interplay between Global, European and National Normative Processes* (2008) (footnote numbering adjusted for this document).

<sup>30</sup> See, e.g., IOSCO, Executive Committee, IOSCO Consultation Policy And Procedure, (Apr. 2005) available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD197.pdf> . Cf. R. D. Kelemen & Eric C. Sibbitt, *The Globalization of American Law*, 58 INT'L ORG. 103 (2004)

<sup>31</sup> See generally, e.g., C. Bradley, *Private International Law-Making for the Financial Markets*, 29 FORDHAM INT'L L. J. 127, 140-154 (2005).

<sup>32</sup> See, e.g., B. Kingsbury, N. Krisch, and R. B. Stewart, *The Emergence of Global Administrative Law*, 68 LAW AND CONTEMPORARY PROBLEMS 15, 16 (2005) (noting "an accountability deficit in the growing exercise of transnational regulatory power.")

<sup>33</sup> Cf. EU Commission, Green Paper: European Transparency Initiative, COM (2006) 194, May 3, 2006.



more likely than financial firms to be excluded from effective participation in supranational standard-setting due to the combined effects of opaque processes, framing, and lack of resources.

Some harmonised rules are set out in binding legal instruments, others are only hortatory. Even the EU's binding harmonisation measures sometimes leave to the Member States some discretion about how to implement the directives within their domestic legal systems.<sup>34</sup> Non-binding standards developed by bodies such as IOSCO may be implemented differently by different states, or may not be implemented at all.<sup>35</sup> However, even formally hortatory standards derive greater force, and become harder for domestic legislators and regulators to ignore, because international financial institutions (IFIs) such as the IMF encourage governments to adopt these standards.<sup>36</sup>

Financial regulation involves complex issues of regulatory jurisdiction, in which jurisdiction is allocated horizontally between authorities in different territorial areas,<sup>37</sup> and vertically between authorities at different hierarchical levels within states, and at the supranational (regional or global) levels.<sup>38</sup> Within a domestic legal system the source for a rule of financial regulation may be sub-national, national, or supranational. Rules for the allocation of regulatory jurisdiction are established in statutes and treaties, but there can be uncertainty about the proper interpretation of the rules.<sup>39</sup>

Standards which are formally harmonised at the supranational level usually need to be implemented within domestic regulatory systems. Implementation is sometimes multilayered and indirect. For example, the Basle Committee has developed capital adequacy standards for banks

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<sup>34</sup> Firms have suggested that the UK is too prone to "gold-plate" its rules: going further than is required by the directives. Cf. Financial Services Authority (hereafter "FSA"), *Better Regulation Action Plan*, London: FSA, December 2005, at p. 6 ("Our basic approach is to 'copy out' the text in our Handbook, adding interpretive guidance where that will be helpful. This avoids placing unintended additional obligations on firms. We will not gold-plate EU requirements. We will only add additional requirements when these are justified in their own right.")

<sup>35</sup> See, e.g., D. E. Alford, *Core Principles for Effective Banking Supervision: an Enforceable International Financial Standard?*, 28 B. C. INT'L & COMP. L. REV. 237, 286 (2005) ("because the agreements are not legally enforceable, nations can vary in their own interpretation and implementation of the standards.")

<sup>36</sup> See, e.g., *idem* at pp. 286-289.

<sup>37</sup> In some states, such as the US, jurisdiction is also splintered among different functional regulators. See, e.g., H. M. Schooner and M. Taylor, *United Kingdom and United States Responses To the Regulatory Challenges of Modern Financial Markets*, 38 Tex. Int'l L. J. 317 (2003)

<sup>38</sup> The complex web of regulation includes a significant component of privately generated standards and codes and contracts which may have quasi-regulatory effects. See, e.g., Bradley, *loc. cit.* note [31](#) at pp. 158-179.

<sup>39</sup> Cf. S. Issacharoff and C. M. Sharkey, *Backdoor Federalization*, 53 UCLA L. Rev., 2006, p. 1353 at p. 1366 ("preemption battles have been largely confined to the realm of statutory interpretation.")

involved in international banking.<sup>40</sup> Within the EU, capital adequacy requirements are an aspect of harmonised regulation of credit institutions, and the EU's capital adequacy rules are being amended to reflect the new Basle standards.<sup>41</sup> Competent authorities within the Member States are responsible for adjusting domestic capital adequacy requirements to reflect the new Basle standards as reflected in EU implementing measures.<sup>42</sup>

Where domestic legislators and regulators have discretion about how they carry out implementation, there are usually multiple points for influencing the regulatory process. Many different actors have a stake in the outcomes of these multi-level or multi-stage regulatory processes, from financial firms and their advisors to corporate and individual consumers of financial services.<sup>43</sup> But some stakeholders are in a better position to influence regulatory outcomes because of superior financial and other resources.

Financial trade associations ("FTAs") and their members now take advantage of opportunities to influence regulatory policy within multi-level systems. In particular, FTAs use two rhetorical strategies that tend to promote the interests of their members and which work against the interests of consumers. The first of these strategies is "market protection rhetoric." In relation to rule-making at the domestic or supranational level, FTAs often invoke arguments that particular proposals will interfere with the proper functioning of the financial markets. Market protection rhetoric is based in claims of expertise and usually implies that those invoking it are in a unique position to understand the market. Market protection rhetoric includes arguments for self-regulation based on expertise.

The FTAs' other routine strategy relies on "harmonisation rhetoric," which is invoked in the context of domestic regulatory action.<sup>44</sup> Harmonisation rhetoric involves an argument that the rules in one domestic jurisdiction should not be stricter than those in another. The argument appears in the

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<sup>40</sup> BIS, Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version*, Basel: BIS, June 2006.

<sup>41</sup> See Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions, O.J. No. L177/1, June. 30, 2006. The Committee of European Banking Supervisors (hereafter CEBS) has sought comments on details of the implementation of the new rules. See, e.g., CEBS, *Consultation Paper on the Guidelines for a Common Approach to the Recognition of External Credit Assessment Institutions (ECAIS)*, CP07, London: CEBS, June 29, 2005.

<sup>42</sup> See, e.g., FSA, *Strengthening Capital Standards*, CP 05/03, London: FSA, January 2005.

<sup>43</sup> The decision-makers in the supranational bodies also have a stake in the regulatory process, as do legislators and regulators. Cf. Braithwaite & Drahos, *Global Business Regulation*, Cambridge: Cambridge University Press, 2000, at 23 ("Each regulatory domain has a distinct range of actors contending for victory at different sites.")

<sup>44</sup> Harmonisation rhetoric is only necessary in the context of the development of supranational rules and standards in order to limit the discretion of the implementing authorities.



context of implementation of supranational standards or rules (for example, arguments against gold-plating when implementing EU directives)<sup>45</sup> and also arises to oppose rules proposed by domestic regulators that lack a supranational source. Harmonisation rhetoric can be seen as a subset of market protection rhetoric because those who invoke it would argue that more onerous rules in one jurisdiction limit the ability of firms established there to compete with firms established elsewhere. Harmonisation rhetoric may also include arguments for self-regulation, on the basis that self-regulatory standards and codes may be able to operate more effectively across territorial boundaries than state-based regulation.<sup>46</sup>

Although the characterization of financial regulation as a system of multi-level governance is useful in some ways, and links to multi-level governance in other fields, the idea of multi-level governance does not fully capture the ways in which transnational financial regulation is developing. It may be useful to characterize transnational financial regulation as a series of intersections between different regulatory spheres rather than as a multi-layered regime for four sets of reason. First, whereas constitutional or treaty-based systems explicitly or implicitly allocate the jurisdiction to make rules to different levels of the system, most transnational financial regulation involves the establishment of agreed, but formally non-binding, standards, rather than an allocation of jurisdiction to make rules. The relationships between the supranational bodies and nation states are qualitatively different from those between the states and their component entities. Second, characterizing the regulatory system as a system of layers may tend to generate normative conclusions about where jurisdiction to regulate financial activity should be exercised.<sup>47</sup> Thinking about regulatory spheres might be less likely to generate

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<sup>45</sup> See, e.g., S. Schaefer and E. Young, *Burdened by Brussels or the UK? Improving the Implementation of EU Directives*, London: Foreign Policy Centre, August 2006, at pp 10-11 (“Rules agreed at the EU level are vital for the proper functioning of the single market. But they can also hamper competitiveness and productivity if they add a differently sized burden in individual member states because they have been implemented in different ways. Gold-plating, as defined by an ongoing audit by HM Treasury, is part of a larger category of over-implementation which also includes double-banking or regulatory creep.”)

<sup>46</sup> Cf. N. S. Poser, *The Stock Exchanges of the United States and Europe: Automation, Globalization and Consolidation*, 22 U. Penn. J. Int'l Econ. L. 497, 538 (2001) (“These are not rules promulgated by a government agency, but by contractual arrangements among the participants. This suggests that self-regulation has the ability to finesse the problems of national sovereignty and differing legal systems that stand in the way of developing and enforcing common governmental regulatory standards.”)

<sup>47</sup> Discussions of pre-emption and subsidiarity tend to assume that there is an appropriate location for jurisdiction with respect to a particular issue. But jurisdiction can be seen as involving choices which are inherently political.

such a result. Third, the terminology of layers or levels tends to imply that the relevant issues involve vertical relationships, whereas thinking in terms of regulatory spheres invites us to think in terms of more complex, and more descriptively realistic, categories of relationship. Finally, any implication that transnational standard-setting is at the top of a regulatory hierarchy is problematic when transnational standard-setting is not subject to administrative law norms or mechanisms for judicial review, and where transnational standard-setters themselves set the principles by which they develop their standards.

Transnational financial regulation involves intersections between governmental and non-governmental or private spheres; between the spheres of expertise and of politics; and between the domestic and foreign or international spheres. Financial regulation has both governmental and non-governmental components. In the administrative state, regulators seek comments on regulatory proposals. Financial regulatory systems include self-regulatory organizations (SROs) as well as governmental regulators, and accommodate privately generated standards and codes. SROs are involved both in the generation of rules and in the enforcement of regulation. Courts interpret and apply standard form contracts generated by non-governmental bodies in ways that sometimes seem to be the equivalent of recognizing the law-making effect of actions of private actors.<sup>48</sup>

Private regulation of financial activity precedes governmental control.<sup>49</sup> exchanges have traditionally controlled the conduct of their members and were incorporated into governmental regulatory systems in order to make governmental regulation more palatable to market participants. A recent and voluminous literature on regulation has advocated a decentering of regulation and a move away from command and control forms of regulation, although some policy-makers reacted to the global financial crisis by rethinking the appropriate balance between self-regulation and governmental regulation.

The term "self-regulation" has been used in different ways in different contexts,<sup>50</sup> and comparing and contrasting self-regulation and governmental regulation, and defining the relationships between them, are complex tasks. The official terminology that legislators and other governmental and inter-governmental actors use to describe a regulatory system is not

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<sup>48</sup> For example, courts have recognized and given effect to standard form contracts and practices in the distressed debt market. See, e.g., *Bear Stearns Bank PLC v Forum Global Equity Ltd.* [2007] EWHC 1576 (Comm) at <http://www.bailii.org/ew/cases/EWHC/Comm/2007/1576.html>.

<sup>49</sup> See, e.g., Paul Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1457 (1997).

<sup>50</sup> See Caroline Bradley, *Reconfiguring the Self in Self-Regulation* (Draft: October 5, 2008) available at <http://blenderlaw.umlaw.net/wp-content/uploads/2008/10/bradleyselfart008.pdf> (examining the concept of the self in self regulation).

always a reliable descriptor of the system, and may even be designed to allow different communities to interpret the balance between governmental and non-governmental authorities differently. For example, as part of its work on the development of transnational standards for securities regulation, IOSCO focused on the role of credit rating agencies (CRAs) in analyzing the credit risk of issuers of securities. Although IOSCO presented the work it did with respect to developing principles and fundamentals for the regulation of CRAs as encouraging self-regulation, CRAs were only part of the story. The initial consultation document on fundamentals for CRA Codes of Conduct noted that it had been developed with input from CRAs.<sup>51</sup> But IOSCO is an organization of securities commissions; in seeking to develop rules for CRAs, IOSCO sought input from two other inter-governmental regulator organizations, the Basel Committee of Banking Supervisors, and the International Association of Insurance Supervisors.<sup>52</sup> The system developed for the “self-regulation” of CRAs involved standards developed through a mixed governmental and non-governmental process, to be implemented by CRAs but subject to the supervision of some domestic regulators.<sup>53</sup>

The term "self-regulation" is inherently slippery and imprecise, combining two apparently conflicting ideas. It is a term which may disguise a regulatory structure in which there is more governmental control than market participants might think desirable, and more independence from governmental control than the public and, in particular retail consumers of financial services, might want. Statutory constraints on SROs limit self-regulation, allow governments to distance themselves from regulatory failures, and restructure the competitive landscape of markets.

Some non-governmental groups, such as exchanges and trade associations, exercise regulatory or quasi -regulatory authority. In addition, firms and their trade associations lobby to

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<sup>51</sup> IOSCO, Code Of Conduct Fundamentals For Credit Rating Agencies, Consultation Report from the Technical Committee Chairmen Task Force on CRAs (Oct. 2004) *available at* <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD173.pdf> .

<sup>52</sup> *Id.*

<sup>53</sup> Since the crisis CRAs have been subjected to new formal regulation in recognition that self-regulation had been incompletely effective. *See, e.g.*, IOSCO, Supervisory Colleges for Credit Rating Agencies: Consultation Report (Dec. 2012) at 1 (“Since 2006, an increasing number of IOSCO members have established registration and oversight programs for CRAs. Supervision of the CRAs includes examinations and inspections conducted on-site and remotely of the CRAs’ books and records. IOSCO’s evaluation of CRA regulatory programs across different jurisdictions reveals that while the structures, specific provisions, and level of implementation of those programs may differ, the objectives of the four IOSCO CRA principles – quality and integrity of the ratings process; management of conflicts; transparency; and treatment of confidential information – are embedded into each of the programs. Indeed, the IOSCO CRA principles appear to be the building blocks upon which CRA regulatory programs have been constructed.”)

influence the development of regulation by governmental regulatory agencies. Financial firms and the trade associations which represent them have for some time used two inter-linked rhetorical strategies to influence the development of transnational financial regulation, which I have called harmonization rhetoric and market protection rhetoric.<sup>54</sup> Market protection rhetoric involves claims that governmental regulation should not interfere too much with market activity, and governments have been receptive to such arguments, for example when they have adopted Better Regulation agendas.<sup>55</sup> The transnational financial market crisis has created pressure for more governmental regulation (such as the Dodd-Frank Act).<sup>56</sup>

In some areas, such as the regulation of money laundering and controls imposed on alleged terrorists, financial regulation is used as a tool of criminal or security law. Here, we see a different relationship between the government and non-governmental entities, as financial firms are enrolled as gatekeepers and monitors in relation to the activities of their customers. Participating in law enforcement is part of the price of the financial firm's license to do business.

In many ways, therefore, governmental authorities and non-governmental participants in the financial markets negotiate their respective roles in the control of financial activity. And the results of such negotiations vary in different places and at different times, and even with respect to different types of activity.

Formal financial regulation is constructed in two modes: the political and the technocratic. Legislatures may focus on financial regulation as part of a program of restructuring and updating regulation more generally, or they may legislate with respect to the financial markets as a result of scandals and crises. However, much of the time rules of financial regulation are developed by means of administrative rule-making, a technocratic process where the power to make detailed rules is delegated to bodies with expertise in particular areas. Administrative agencies are not immune to politics, as they are subject to political control: legislatures set the constraints within which they operate, and politicians appoint the people who run the agencies. The funding arrangements for agencies may be designed to give them more or less freedom

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<sup>54</sup> See, e.g., Caroline Bradley, *Financial Trade Associations and Multilevel Regulation*, in Ramses Wessel, Andreas Follesdal & Jan Wouters eds., *MULTILEVEL REGULATION AND THE EU: THE INTERPLAY BETWEEN GLOBAL, EUROPEAN AND NATIONAL NORMATIVE PROCESSES* (2008).

<sup>55</sup> See, e.g., Financial Services Authority, *Better Regulation Action Plan*, London: FSA, December 2005. More recently policy-makers have referred to "smart regulation" or regulatory fitness. See e.g., EU Commission Communication, *EU Regulatory Fitness*, COM (2012) 746 final (Dec. 12, 2012) at [http://ec.europa.eu/governance/better\\_regulation/documents/1\\_EN\\_ACT\\_part1\\_v8.pdf](http://ec.europa.eu/governance/better_regulation/documents/1_EN_ACT_part1_v8.pdf).

<sup>56</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, July 21, 2010.

from political control.<sup>57</sup>

Many areas of financial regulation involve combinations of issues which are technical (and of little obvious interest to consumers) and issues which are directly relevant to consumers. Before the financial crisis it was not obvious that consumers of financial services generally should care too much about the details of capital adequacy regulation of financial institutions. But as the crisis has unfolded it has become clear that individual consumers' ability to borrow money and the value of their retirement funds were connected in fundamental ways to issues of confidence in financial institutions and the markets. Crises clearly complicate regulatory policy-making by politicizing realms which in other times belong to technocrats and those they regulate, but, even in ordinary times, a more effective, and more legitimate, regime for financial regulation might recognize the inherently political (as well as technical) characteristics of financial regulation.

At the supranational level, whether standard-setters emphasize the technical aspects of their activities or the possible impact on a range of stakeholders beyond financial firms may have a significant impact on whether stakeholders other than financial firms decide to become involved in debating appropriate standards and rules. If financial firms and their trade associations, using market protection rhetoric, successfully induce standard-setters to view their work as involving only technical standards, consumers are less likely to comment on any proposed rules and standards and, as a result, their interests are less likely to be taken into account. Domestic regulators' ability to adopt this perspective is affected by their ability (or lack of ability) to ignore the political implications of their actions. But supranational standard setters such as IOSCO and the Basel Committee are inherently more insulated from the political sphere than are most domestic financial regulators. And, to the extent that standards decisions taken at the supranational level in technocratic rather than political fora are treated as pre-empting the ability of national (and sub-national) authorities to develop rules which deviate from the supranational standards, consumer-voter-taxpayers' interests are prejudiced....

Financial regulation involves complex issues of the division of functions between different authorities. Jurisdiction to prescribe and enforce regulations is allocated horizontally between authorities in different territorial areas, and vertically between authorities at different hierarchical levels within states, and at the supranational (regional or global) levels. Within a domestic legal system the source for a rule of financial regulation may be sub-national, national, or supranational.

Financial activity and transactions are visibly transnational at the wholesale and even at

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<sup>57</sup> For example, whereas the OCC can fund its own operations from its revenues without depending on Congressional appropriations, the SEC depends on them.

the retail level. The development of the remittance market illustrates that even people who are not very wealthy may engage on a regular basis in transnational financial transactions. But although financial activity is often transnational, the rules of financial regulation, and the rules of private law which help to constitute cross-border transactions, are artefacts of domestic legal systems. Thus domestic regulators, legislatures and courts are actors in transnational financial law because of cross-border transactions. From the perspective of enforcement of financial regulation, financial regulators based in different jurisdictions increasingly work together through Memoranda of Understanding (MOUs), through transnational standard-setting organizations, and in the context of supervision and enforcement. Financial firms and their trade associations often argue for harmonization of regulation in order to reduce disparities in regulation and the concomitant compliance costs or competitive inequalities.<sup>58</sup>

The rate and volume of harmonization of financial regulation continue to increase thanks to multiple initiatives and to the recent financial crisis. Major international efforts include the work of IOSCO, the Basle Committee on Banking Supervision, and the IAIS to develop harmonized principles of financial regulation and the EU's effort to achieve a single market in financial services.<sup>59</sup> Although the EU's rules often leave very little discretion as to implementation to EU Member States, as a practical matter, as states act to implement supranational standards at the domestic level, they usually have a significant amount of discretion to adapt the standards to local conditions. Often supranational standards are drafted as very general (or "high-level") principles leaving significant scope for the exercise of discretion in implementation. Where such discretion exists, financial firms and their trade associations have double opportunities for lobbying to affect the rules which are adopted: they can lobby at the supranational level when the standards are agreed and again at the national level when the standards are transformed into domestic law. Financial firms and trade associations are in a better position than other stakeholders to influence regulatory outcomes because they have superior financial and other resources.

Within a federal or federal-type system, the foundational documents will set principles for

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<sup>58</sup> See, e.g., Italian Banking Association, response to CEBS' draft of high-level principles on Remuneration Policies (Apr.6, 2009) at [http://www.c-ebs.org/getdoc/5b3cfde0-3d16-41c6-a632-ba7dc444414e/CP23\\_Italian-Banking-System.aspx](http://www.c-ebs.org/getdoc/5b3cfde0-3d16-41c6-a632-ba7dc444414e/CP23_Italian-Banking-System.aspx) ("any initiative at EU level should preferably take into account progress at the international level. Indeed the Banking Industry operates in a global environment and as such there is a need for a coordinated response from regulators. Any initiatives which only impact banks headquartered in Europe could put those firms at a competitive disadvantage.")

<sup>59</sup> See, e.g., EU Commission, *Financial Services: Implementing the Framework for Financial Markets: Action Plan*, COM (1999) 232, May 11, 1999.

the allocation of jurisdiction to make rules about various matters. Although the interpretation of these documents by courts and legislators may be fluid and involve political assessments and may change over time, there is an underlying set of agreements about the allocation of jurisdiction. The transnational system for the regulation of financial activity does not (yet) involve such foundational documents or even agreements. Governmental authorities in different jurisdictions work together in groups with varying memberships to establish standards which have a greater coercive impact on some states than on others. Whereas IOSCO has 115 ordinary members, the Basel Committee has 27. But while the standards developed by IOSCO and the Basel Committee are formally not binding, the IMF encourages states to implement the standards (including states which are not able to participate directly in developing the standards) through its Standards and Codes initiative, and has recently developed its idea of surveillance to include financial regulation as a component of financial stability.<sup>60</sup>

The processes for developing supranational standards of financial regulation are not inclusive, and tend to privilege the wealthiest countries. Although the Basel Committee expanded its membership after the onset of the financial crisis, showing some sensitivity to this issue, it is still a very select group. Supranational standard setters have responded to critiques of their legitimacy by developing more formal processes, by consulting on proposed standards, and even by establishing consultation policies.<sup>61</sup> However, despite these developments, there are still some very visible differences between consultations carried out by supranational bodies and those carried out by domestic regulators (or even by EU institutions).<sup>62</sup> Although the supranational standard setters may voluntarily undertake to comply with what they understand to be best practices with respect to consultation, their actions are not subject to any kind of judicial review at the supranational level.<sup>63</sup>

Defects in the processes for developing supranational standards matter because financial trade associations seek to invoke harmonization rhetoric at the national level when

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<sup>60</sup> See, e.g., IMF, *The IMF's Financial Surveillance Strategy* (Aug. 28, 2012) at <http://www.imf.org/external/np/pp/eng/2012/082812.pdf>.

<sup>61</sup> See, e.g., IOSCO, Executive Committee, *IOSCO Consultation Policy And Procedure*, IOSCO: Madrid, April 2005.

<sup>62</sup> The EU still has a noticeable democratic deficit but its processes for consultation are formalized, and subject to judicial review.

<sup>63</sup> For example, even where people are designated as terrorists for the purposes of sanctions, including restriction of access to bank accounts, they may not have any right to challenge the designation at the supranational level. See, e.g., Simon Chesterman, *The Spy Who Came in from the Cold War: Intelligence and International Law*, 27 MICH. J. INT'L L. 1071 (2006).



states are implementing supranational standards, arguing that domestic regulators should not impose more restrictive rules than those provided for in the standards or by other domestic regulators which are implementing them. In the EU, for example, financial firms have argued that the UK authorities should not “gold-plate” measures which implement EU directives.<sup>64</sup> Financial firms and their trade associations use harmonization rhetoric to suggest to domestic regulators that they should regard themselves as pre-empted by supranational standards, or even by foreign rules on the basis that imposing stricter standards on firms they regulate will put those firms at an unfair competitive disadvantage in the transnational markets.

As governments emphasize the development of standards of financial regulation at the supranational level, and particularly if those standards are more specific than they have been, and if the IMF exerts greater pressure on countries to implement standards, it becomes increasingly important to develop a supranational administrative law, rather than relying on self-regulation by the standard-setters.

The EU seeks to integrate financial markets by removing barriers and by agreeing on harmonized rules on financial services, but the process of harmonizing the rules is a slow one. Harmonization of regulation is difficult even where the countries involved are at similar levels of economic development, and have similar cultural environments. Where culture and history diverge, harmonization is even more problematic.<sup>65</sup> We will think about regulatory harmonization in more detail later.

The promotion of free trade in financial services is one reason for promoting harmonization of financial regulation. Another is the desire of governments and regulators in developed countries to protect their financial markets from various types of threat from other countries. If countries generally had similar levels of investor protection, then they would not need to worry about protection of their own residents who decided to invest abroad. Harmonization of regulation is an alternative to extraterritorial application of rules.

Regulatory harmonization also limits the ability of firms to escape regulation by moving their activities into another jurisdiction (regulatory arbitrage). International harmonization of money laundering regulation is an example of this concern at work. In November 2002 the IMF agreed to include “ the Financial Action Task Force (FATF) 40 Recommendations on an

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<sup>64</sup> See, e.g., FSA, *supra* note [55](#). The terminology of gold-plating combines market protection and harmonization rhetoric.

<sup>65</sup> See, e.g., V Sundararajan & Luca Errico, *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead*, IMF Working Paper WP/02/192, (Nov. 2002) available at <http://www.imf.org/external/pubs/ft/wp/2002/wp02192.pdf> (describing problems of applying Western risk management principles to Islamic financial products and services).



effective anti-money laundering framework, and the 8 Special Recommendations on Terrorism Financing<sup>66</sup> (FATF 40+ 8), in the list of areas and associated standards and codes that are incorporated into the operational work of the Fund”.<sup>67</sup> This meant that the IMF would monitor the application of these recommendations as it monitors other aspects of the countries whose affairs it reviews.

Legal harmonization is also designed to protect countries from the effects of financial crises which affect other countries. A large body of literature connects the level of development of a country’s securities markets with its economic health. It has been argued that countries with strong securities markets tend to have high levels of economic growth.<sup>68</sup> Increasing standards of regulation in less developed economies therefore not only protects developed economies by reducing the likelihood of crises which might infect the developed economies, but also benefits less developed economies more directly. Some commentators have challenged the idea that changing legal rules necessarily promotes economic development.<sup>69</sup> And some critics of harmonization have argued that legal harmonization has risks:

I am also concerned that the effort to homogenize capital rules across the world may do serious damage to certain markets in which U.S. banks – particularly national banks – have been world leaders, such as credit cards and securitizations. We have to exercise great caution that we do not, in the name of achieving international uniformity, needlessly disrupt settled banking practices and established, well-functioning markets.<sup>70</sup>

Some commentators argue that rather than emphasizing harmonization of law and regulation we should allow different countries to compete with each other in the laws and

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<sup>66</sup> See above at ?.

<sup>67</sup> IMF Press Release, *IMF Executive Board Approves 12-Month Anti-Money Laundering Pilot Project*, No. 02/52 (Nov. 22, 2002) available at <http://www.imf.org/external/np/sec/pr/2002/pr0252.htm> . For FATF’s activities, see

<sup>68</sup> See, e.g., Bharat N. Anand & Alexander Galetovic, *Investment Banking and Security Market Development*, IMF Working Paper, WP/01/90, July 2001, available at <http://www.imf.org/external/pubs/ft/wp/2001/wp0190.pdf>.

<sup>69</sup> See, e.g., Gordon Smith, *Taking Legal Origins Theory Seriously*, Jotwell (Jan. 7, 2011) at <http://corp.jotwell.com/taking-legal-origins-theory-seriously/> .

<sup>70</sup> John D. Hawke, Jr., (then) Comptroller of the Currency, *Basel II: A Brave New World for Financial Institutions?*, speech to the American Academy in Berlin, Dec. 15, 2003, available from <http://www.occ.treas.gov/ftp/release/2003-99a.pdf> .

regulations they apply, because such legal and regulatory competition will produce the most efficient regulatory outcomes. However some harmonization is happening. At the beginning of 2010, the Financial Stability Board published the **FSB Framework for Strengthening Adherence to International Standards**.<sup>71</sup>

The FSB is committed to strengthening adherence to international financial standards. Financial markets are global in scope and, therefore, consistent implementation of international standards is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability.

The FSB, working through the Standing Committee on Standards Implementation, will foster a race to the top, wherein encouragement from peers motivates all countries and jurisdictions to raise their level of adherence to international financial standards. Encouragement will come in three forms.

First, FSB member jurisdictions will lead by example. FSB member jurisdictions have committed to implementing international financial standards and disclosing their level of adherence.

Second, FSB member jurisdictions will undergo periodic peer reviews to evaluate their adherence to international standards in the regulatory and supervisory area. Such evaluations will provide members with feedback from peers on the implementation and effectiveness of standards and policies. Moreover they will encourage non-FSB member jurisdictions to undergo similar evaluations.

Third, the FSB will establish a toolbox of measures to encourage adherence to international cooperation and information exchange standards by all countries and jurisdictions. Application of these measures will be based on transparent procedures to evaluate the degree of adherence of jurisdictions to the relevant standards.

...FSB members' adherence to international standards is essential to reinforce the credibility of the FSB's efforts to strengthen adherence by all countries and jurisdictions. To lead by example, FSB member jurisdictions have committed to:

implementing international financial standards;

undergoing an assessment under the IMF-World Bank Financial Sector Assessment Program (FSAP) every five years;

disclosing their degree of adherence of international standards, notably by publishing the detailed assessments prepared by the IMF and World Bank as a basis for the Reports on the Observance of Standards and Codes (ROSCs); and

undergoing periodic peer reviews using, among other evidence, reports prepared as part of the FSAP.

All 24 FSB member jurisdictions have participated or are in the process of participating in the FSAP ...

An initial FSAP was completed in 20 member jurisdictions (five of which also completed an FSAP Update) and is currently under way in a further three jurisdictions, while an FSAP was not completed in the case of one member jurisdiction.

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<sup>71</sup> At [http://www.financialstabilityboard.org/publications/r\\_100109a.pdf](http://www.financialstabilityboard.org/publications/r_100109a.pdf) .

... FSB member jurisdictions have committed to undergoing periodic peer reviews focused on the implementation and effectiveness of international financial standards and of policies agreed within the FSB. The peer reviews will build on, and avoid duplicating, existing assessment mechanisms, such as FSAPs and ROSCs. The added value of FSB peer reviews will come in significant part from the cross-sector, cross-functional, system-wide perspective brought by its members. Dialogue with peers will be a key benefit of the reviews.

FSB member jurisdictions have agreed to undergo both thematic and country peer reviews. Thematic peer reviews will focus on the implementation across the FSB membership of policies or standards agreed within the FSB, with particular attention to consistency in cross-country implementation and the effectiveness of the policy or standard in achieving the intended results. Country peer reviews will focus on the implementation and effectiveness of financial sector standards and policies agreed within the FSB in achieving the desired outcomes in a specific member jurisdiction, notably through systematic and timely follow up to relevant recommendations arising from an FSAP or ROSC.

FSB peer reviews will be based on reports drafted by small teams composed of experts from FSB member jurisdictions and international bodies, supported by the FSB Secretariat. The substantive review by peers will take place in the Standing Committee on Standards Implementation. The final responsibility for approving FSB peer reviews lies with the Plenary, as the decision-making body of the FSB. In keeping with the FSB's commitment to lead by example, peer review reports will be published, along with any commentary provided by the reviewed jurisdictions for inclusion. Following publication of the report, jurisdictions' implementation of agreed actions will be monitored by the FSB and, if implementation lags, peer pressure may be applied. Guidelines for the conduct of FSB peer reviews are set out in a Handbook for FSB Peer Reviews that will be revised and expanded as experience is gained.

Thematic and country reviews will move forward in parallel. The first thematic review is on actions taken by firms and national authorities to implement the FSB Principles and Implementation Standards for Sound Compensation Practices. This review will be completed by March 2010. The FSB aims to complete two more thematic reviews and three country reviews in 2010.

...The FSB is finalising procedures to encourage the adherence of all countries and jurisdictions to international financial standards, including by identifying non-cooperative jurisdictions and assisting them to improve their adherence. This initiative responds to a call by G20 Leaders at the April 2009 London Summit and complements initiatives by the Global Forum and OECD to promote adherence to international standards in the tax area, and by FATF for standards concerning anti-money laundering and combating the financing of terrorism.

Of particular concern to the FSB is the adherence of jurisdictions to international cooperation and information exchange standards in the financial regulatory and supervisory area. The three key standards in the regulatory and supervisory area are: the BCBS Core Principles for Effective Banking Supervision; the IAIS Insurance Core Principles; and the IOSCO Objectives and Principles of Securities Regulation.... The initial focus of the FSB is on jurisdictions that could pose a risk to financial stability because of their importance in the financial system and their weak adherence to the relevant standards. Over time, the FSB will reassess this focus and may adjust it to other potential areas of concern or

groups of jurisdictions.

The FSB is prioritising a pool of jurisdictions to engage in dialogue in order to further evaluate their adherence to the relevant standards and possible ways to improve adherence. Prioritisation will take place according to available information on jurisdictions' importance in the financial system and on their compliance with the relevant standards.

In order to measure financial importance, a combination of the following economic and financial indicators will be considered to rank jurisdictions:

Domestic financial assets, both in absolute terms and relative to national GDP.

External financial assets and liabilities of a jurisdiction as measured by creditor-side data, specifically the BIS international banking statistics and the IMF Coordinated Portfolio Investment Survey.

Gross capital flows, both in absolute terms and relative to national GDP.

Market share in selected global market segments. Five market segments will be considered:

cross-border interbank assets, pension fund assets, hedge fund assets (based on both the location of the manager and the legal domicile of the fund), over-the-counter derivatives markets, and insurance premiums.

The adherence of jurisdictions to the relevant standards will be evaluated using information on compliance from ROSCs prepared by the IMF and World Bank, and Multilateral Memoranda of Understanding (MMoU). A jurisdiction that is either "compliant" or "largely compliant" in all, or all except one, of the relevant international cooperation and information exchange principles ... will not require further evaluation. In the case of principles in the securities regulation area, signature of the IOSCO MMoU Concerning Consultation and Cooperation and the Exchange of Information will be considered as sufficient evidence of compliance.

All FSB member jurisdictions will be held to the same standard, and be subject to the same evaluation process, as will be applied to non-member jurisdictions. The FSB will actively engage in external outreach and communications to ensure that the process and potential outcomes of this dialogue to promote and strengthen adherence to international standards are fully explained and understood.

The FSB's dialogue with jurisdictions will evaluate areas of weakness, consider cooperation with international assessment processes, examine where further information is needed, identify priorities for reform, and recommend actions to address weaknesses. To support the efforts of low-capacity jurisdictions to achieve adherence with international standards, capacity-building mechanisms will be made available to provide technical assistance. A toolbox of potential measures to promote adherence is being finalised. The toolbox will be a balance of positive and negative measures, and will include the option of publishing by the end of 2010 the names of non-cooperative jurisdictions in the event that other measures to promote adherence to international cooperation and information exchange standards are not achieving sufficient progress.

The process for implementing these changes is a slow one.<sup>72</sup>

## OBJECTIVES OF BANKING REGULATION AND SECURITIES REGULATION

The transnational standard-setters that focus on financial regulation have different bodies which focus on different aspects of financial regulation (IOSCO for securities regulation and the Basel Committee for bank regulation). Some domestic regulators are organized to regulate many different types of financial activity, and other systems such as that in the US have many separate regulators for different types of financial activity. Shadow banking raises issues about how firms which perform functions like those of banks should be regulated.

**Daniel Tarullo, a Governor of the Federal Reserve** has addressed this issue:

... it is noteworthy that while the term "shadow banking system" has taken its place in the lexicon of policymakers alongside "systemic risk" and "financial stability," comparatively little has been done to regulate the channels of capital flows in which one or both transacting parties lie outside the perimeter of prudentially supervised institutions. This despite the often considerable degree of leverage and maturity transformation associated with many of these channels. In part, the relative lack of reform directed at the shadow banking system is a result of the fact that it was substantially disrupted by the financial crisis, and that some of its more unstable parts have fortunately disappeared. Yet there are certainly significant pieces that have survived and that serve important purposes in financial markets. I have already mentioned money market funds as one example. Although many broker-dealers are parts of bank holding companies, the breadth and significance of the repo market suggest that it may be another. Just as important as dealing with systemic risks that might be posed by vestiges of the pre-crisis shadow banking system is the ability to monitor and, where necessary provide oversight for, the new conduits that are almost surely to develop in the future. In fact, it may be useful to require some systematic and standardized reporting by some classes of nonbank-affiliated firms, even without a designation under section 113.

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

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<sup>72</sup> See, e.g., Financial Stability Board, Progress of Financial Regulatory Reforms (Nov. 9, 2010) at [http://www.financialstabilityboard.org/publications/r\\_101109.pdf](http://www.financialstabilityboard.org/publications/r_101109.pdf) ; G-20 Mutual Assessment Process—IMF Staff Assessment of G-20 Policies (Oct. 2010) at <http://www.imf.org/external/np/g20/pdf/111210.pdf> .

bear more of the weight in policies crafted to contain systemic risk.<sup>73</sup>

### **Section 113 of the Dodd-Frank Act:**

Sec. 113. Authority to Require Supervision and Regulation Of Certain Nonbank Financial Companies.

(A) US Nonbank Financial Companies Supervised by the Board of Governors.. (1) Determination..The Council,<sup>74</sup> on a nondelegable basis and by a vote of not fewer than 2.3 of the voting members then serving, including an affirmative vote by the Chairperson, may determine that a U.S. nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards, in accordance with this title, if the Council determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.

(2) Considerations..In making a determination under paragraph (1), the Council shall consider. (A) the extent of the leverage of the company; (B) the extent and nature of the off-balance-sheet exposures of the company; (C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (D) the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system; (E) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities; (F) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse; (G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (H) the degree to which the company is already regulated by 1 or more primary financial regulatory agencies; (I) the amount and nature of the financial assets of the company; (J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and (K) any other risk-related factors that the Council deems appropriate

(b) Foreign Nonbank Financial Companies Supervised by The Board of Governors..

(1) Determination..The Council... may determine that a foreign nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards, in accordance with this title, if the Council determines that material financial distress at the foreign nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the foreign nonbank financial company, could pose a threat to the financial stability of the United States.

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<sup>73</sup> Governor Daniel K. Tarullo, Regulating Systemic Risk, Speech at the 2011 Credit Markets Symposium, Charlotte, North Carolina (Mar. 31, 2011) at <http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.htm>.

<sup>74</sup> This is the Financial Stability Oversight Council (a interagency council) : <http://www.treasury.gov/initiatives/Pages/FSOC-index.aspx> . See FSOC, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637 (Apr. 11, 2012).

(2) Considerations.—In making a determination under paragraph (1), the Council shall consider— (A) the extent of the leverage of the company; (B) the extent and nature of the United States related off-balance-sheet exposures of the company; (C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (D) the importance of the company as a source of credit for United States households, businesses, and State and local governments and as a source of liquidity for the United States financial system; (E) the importance of the company as a source of credit for low-income, minority, or underserved communities in the United States, and the impact that the failure of such company would have on the availability of credit in such communities; (F) the extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse; (G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (H) the extent to which the company is subject to prudential standards on a consolidated basis in its home country that are administered and enforced by a comparable foreign supervisory authority; (I) the amount and nature of the United States financial assets of the company; (J) the amount and nature of the liabilities of the company used to fund activities and operations in the United States, including the degree of reliance on short term funding; and (K) any other risk-related factors that the Council deems appropriate.

(c) Antievasion.. (1) Determinations..In order to avoid evasion of this title, the Council, on its own initiative or at the request of the Board of Governors, may determine... that.

(A) material financial distress related to, or the nature, scope, size, scale, concentration, interconnectedness, or mix of, the financial activities conducted directly or indirectly by a company incorporated or organized under the laws of the United States or any State or the financial activities in the United States of a company incorporated or organized in a country other than the United States would pose a threat to the financial stability of the United States, based on consideration of the factors in subsection (a)(2) or (b)(2), as applicable;

(B) the company is organized or operates in such a manner as to evade the application of this title; and  
(C) such financial activities of the company shall be supervised by the Board of Governors and subject to prudential standards in accordance with this title, consistent with paragraph (3).

(2) Report.—Upon making a determination under paragraph (1), the Council shall submit a report to the appropriate committees of Congress detailing the reasons for making such determination.

(3) Consolidated Supervision of Only Financial Activities; Establishment of an Intermediate Holding Company.—

(A) Establishment of an Intermediate Holding Company.—Upon a determination under paragraph (1), the company that is the subject of the determination may establish an intermediate holding company in which the financial activities of such company and its subsidiaries shall be conducted (other than the activities described in section 167(b)(2)) in compliance with any regulations or guidance provided by the Board of Governors. Such intermediate holding company shall be subject to the supervision of the Board of Governors and to prudential standards under this title as if the intermediate holding company were a nonbank financial company supervised by the Board of Governors.

(B) Action of the Board of Governors.—To facilitate the supervision of the financial activities subject to the determination in paragraph (1), the Board of Governors may require a company to establish an intermediate holding company, as provided for in section 167, which would be subject to the supervision of the Board of Governors and to prudential standards under this title, as if the intermediate holding company were a nonbank financial company supervised by the Board of Governors.

(4) Notice and Opportunity for Hearing and Final Determination; Judicial Review.—Subsections (d) through (h) shall apply to determinations made by the Council pursuant to paragraph (1) in the same manner as such subsections apply to nonbank financial companies.

(5) Covered Financial Activities.—For purposes of this subsection, the term “financial activities”—

(A) means activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956);

(B) includes the ownership or control of one or more insured depository institutions; and

(C) does not include internal financial activities conducted for the company or any affiliate thereof, including internal treasury, investment, and employee benefit functions.

(6) Only Financial Activities Subject to Prudential Supervision.—Nonfinancial activities of the company shall not be subject to supervision by the Board of Governors and prudential standards of the Board. For purposes of this Act, the financial activities that are the subject of the determination in paragraph (1) shall be subject to the same requirements as a nonbank financial company supervised by the Board of Governors. Nothing in this paragraph shall prohibit or limit the authority of the Board of Governors to apply prudential standards under this title to the financial activities that are subject to the determination in paragraph (1).

(d) Reevaluation and Rescission..The Council shall. (1) not less frequently than annually, reevaluate each determination made under subsections (a) and (b) with respect to such nonbank financial company supervised by the Board of Governors; and (2) rescind any such determination, if the Council, by a vote of not fewer than 2.3 of the voting members then serving, including an affirmative vote by the Chairperson, determines that the nonbank financial company no longer meets the standards under subsection (a) or (b), as applicable.

(E) Notice and Opportunity for Hearing and Final Determination..

(1) in General..The Council shall provide to a nonbank financial company written notice of a proposed determination of the Council, including an explanation of the basis of the proposed determination of the Council, that a nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards in accordance with this title.

(2) Hearing..Not later than 30 days after the date of receipt of any notice of a proposed determination under paragraph (1), the nonbank financial company may request, in writing, an opportunity for a written or oral hearing before the Council to contest the proposed determination. Upon receipt of a timely request, the Council shall fix a time (not later than 30 days after the date of receipt of the request) and place at which such company may appear, personally or through counsel, to submit written materials (or, at the sole discretion of the Council, oral testimony and oral argument).

(3) Final Determination..Not later than 60 days after the date of a hearing under paragraph (2), the



Council shall notify the nonbank financial company of the final determination of the Council, which shall contain a statement of the basis for the decision of the Council.

(4) No Hearing Requested..If a nonbank financial company does not make a timely request for a hearing, the Council shall notify the nonbank financial company, in writing, of the final determination of the Council under subsection (a) or (b), as applicable, not later than 10 days after the date by which the company may request a hearing under paragraph (2).

(F) Emergency Exception..

(1) in General..The Council may waive or modify the requirements of subsection (e) with respect to a nonbank financial company, if the Council determines,... that such waiver or modification is necessary or appropriate to prevent or mitigate threats posed by the nonbank financial company to the financial stability of the United States.

(2) Notice.—The Council shall provide notice of a waiver or modification under this subsection to the nonbank financial company concerned as soon as practicable, but not later than 24 hours after the waiver or modification is granted.

(3) International Coordination.—In making a determination under paragraph (1), the Council shall consult with the appropriate home country supervisor, if any, of the foreign nonbank financial company that is being considered for such a determination.

(4) Opportunity for Hearing.—The Council shall allow a nonbank financial company to request, in writing, an opportunity for a written or oral hearing before the Council to contest a waiver or modification under this subsection, not later than 10 days after the date of receipt of notice of the waiver or modification by the company. Upon receipt of a timely request, the Council shall fix a time (not later than 15 days after the date of receipt of the request) and place at which the nonbank financial company may appear, personally or through counsel, to submit written materials (or, at the sole discretion of the Council, oral testimony and oral argument).

(5) Notice of Final Determination.—Not later than 30 days after the date of any hearing under paragraph (4), the Council shall notify the subject nonbank financial company of the final determination of the Council under this subsection, which shall contain a statement of the basis for the decision of the Council.

(g) Consultation.—The Council shall consult with the primary financial regulatory agency, if any, for each nonbank financial company or subsidiary of a nonbank financial company that is being considered for supervision by the Board of Governors under this section before the Council makes any final determination with respect to such nonbank financial company under subsection (a), (b), or (c).

(h) Judicial Review.—If the Council makes a final determination under this section with respect to a nonbank financial company, such nonbank financial company may, not later than 30 days after the date of receipt of the notice of final determination under subsection (d)(2), (e)(3), or (f)(5), bring an action in the United States district court for the judicial district in which the home office of such nonbank financial company is located, or in the United States District Court for the District of Columbia, for an order requiring that the final determination be rescinded, and the court shall, upon review, dismiss such action or direct the final determination to be rescinded. Review of such an action shall be limited to whether the

final determination made under this section was arbitrary and capricious.

(i) International Coordination.—In exercising its duties under this title with respect to foreign nonbank financial companies, foreign-based bank holding companies, and cross-border activities and markets, the Council shall consult with appropriate foreign regulatory authorities, to the extent appropriate.

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

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

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

Form the perspective of the regulation of securities issuance by banks, if banking regulators regulate the safety and soundness of banks effectively we should perhaps not worry too much about having the SEC regulate the issuance of securities by banks.<sup>75</sup>

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.

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<sup>75</sup> 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.

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”).<sup>76</sup>

**IOSCO’s Objectives and Principles of Securities Regulation**<sup>77</sup> are based on protecting investors; ensuring that markets are fair, efficient and transparent; and reducing systemic risk:

A. Principles Relating to the Regulator

- 1 The responsibilities of the Regulator should be clear and objectively stated.
- 2 The Regulator should be operationally independent and accountable in the exercise of its functions and powers.
- 3 The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
- 4 The Regulator should adopt clear and consistent regulatory processes.
- 5 The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality.
- 6 The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.
- 7 The Regulator should have or contribute to a process to review the perimeter of regulation regularly.
- 8 The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.

B. Principles for Self-Regulation

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

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<sup>76</sup> 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); 12 CFR Part 218.

<sup>77</sup> <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf> (Jun. 2010).

**C. Principles for the Enforcement of Securities Regulation**

10 The Regulator should have comprehensive inspection, investigation and surveillance powers.

11 The Regulator should have comprehensive enforcement powers.

12 The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

**D. Principles for Cooperation in Regulation**

13 The Regulator should have authority to share both public and non-public information with domestic and foreign counterparts.

14 Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.

15 The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

**E. Principles for Issuers**

16 There should be full, accurate and timely disclosure of financial results, risk and other information which is material to investors' decisions.

17 Holders of securities in a company should be treated in a fair and equitable manner.

18 Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.

**F. Principles for Auditors, Credit Ratings Agencies, and other information service providers**

19 Auditors should be subject to adequate levels of oversight.

20 Auditors should be independent of the issuing entity that they audit.

21 Audit standards should be of a high and internationally acceptable quality.

22 Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.

23 Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.

**G. Principles for Collective Investment Schemes**

24 The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme.

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

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

investor's interest in the scheme.

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

28 Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.

#### H. Principles for Market Intermediaries

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

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

31 Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.

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

#### I. Principles for Secondary Markets

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

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

35 Regulation should promote transparency of trading.

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

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

38 Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

The **Basel Committee's Core Principles for Effective Banking Supervision**, revised in 2012, are set out below:<sup>78</sup>

Supervisory powers, responsibilities and functions

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<sup>78</sup> Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision (Sep. 2012) at <http://www.bis.org/publ/bcbs230.pdf> .

Principle 1 – Responsibilities, objectives and powers:

An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups. A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to authorise banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns.

• Principle 2 – Independence, accountability, resourcing and legal protection for supervisors:

The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor.

• Principle 3 – Cooperation and collaboration:

Laws, regulations or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors. These arrangements reflect the need to protect confidential information.

• Principle 4 – Permissible activities:

The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined and the use of the word "bank" in names is controlled.

• Principle 5 – Licensing criteria:

The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. At a minimum, the licensing process consists of an assessment of the ownership structure and governance (including the fitness and propriety of Board members and senior management) of the bank and its wider group, and its strategic and operating plan, internal controls, risk management and projected financial condition (including capital base). Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home supervisor is obtained.

• Principle 6 – Transfer of significant ownership:

The supervisor has the power to review, reject and impose prudential conditions on any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

• Principle 7 – Major acquisitions:

The supervisor has the power to approve or reject (or recommend to the responsible authority the approval or rejection of), and impose prudential conditions on, major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and to determine that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

• Principle 8 – Supervisory approach:

An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking

system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.

- Principle 9 – Supervisory techniques and tools:

The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach and deploys supervisory resources on a proportionate basis, taking into account the risk profile and systemic importance of banks.

- Principle 10 – Supervisory reporting:

The supervisor collects, reviews and analyses prudential reports and statistical returns from banks on both a solo and a consolidated basis, and independently verifies these reports through either on-site examinations or use of external experts.

- Principle 11 – Corrective and sanctioning powers of supervisors:

The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The supervisor has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability to revoke the banking licence or to recommend its revocation.

- Principle 12 – Consolidated supervision:

An essential element of banking supervision is that the supervisor supervises the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide.

- Principle 13 – Home-host relationships:

Home and host supervisors of cross-border banking groups share information and cooperate for effective supervision of the group and group entities, and effective handling of crisis situations.

Supervisors require the local operations of foreign banks to be conducted to the same standards as those required of domestic banks.

#### Prudential regulations and requirements

- Principle 14 – Corporate governance:

The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organisational structure, control environment, responsibilities of the banks' Boards and senior management, and compensation. These policies and processes are commensurate with the risk profile and systemic importance of the bank.

- Principle 15 – Risk management process:

The supervisor determines that banks have a comprehensive risk management process (including effective Board and senior management oversight) to identify, measure, evaluate, monitor, report and control or mitigate all material risks on a timely basis and to assess the adequacy of their capital and liquidity in relation to their risk profile and market and macroeconomic conditions. This extends to development and review of contingency arrangements (including robust and credible recovery plans where warranted) that take into account the specific circumstances of the bank. The risk management

process is commensurate with the risk profile and systemic importance of the bank.

- Principle 16 – Capital adequacy:

The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable Basel standards.

- Principle 17 – Credit risk:

The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk (including counterparty credit risk) on a timely basis. The full credit lifecycle is covered including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios.

- Principle 18 – Problem assets, provisions and reserves:

The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves.

- Principle 19 – Concentration risk and large exposure limits:

The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate concentrations of risk on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

- Principle 20 – Transactions with related parties:

In order to prevent abuses arising in transactions with related parties and to address the risk of conflict of interest, the supervisor requires banks to enter into any transactions with related parties on an arm's length basis; to monitor these transactions; to take appropriate steps to control or mitigate the risks; and to write off exposures to related parties in accordance with standard policies and processes.

- Principle 21 – Country and transfer risks:

The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate country risk and transfer risk in their international lending and investment activities on a timely basis.

- Principle 22 – Market risks:

The supervisor determines that banks have an adequate market risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions and the risk of a significant deterioration in market liquidity. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate market risks on a timely basis.

- Principle 23 – Interest rate risk in the banking book:

The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate interest rate risk in the banking book on a timely basis. These systems



take into account the bank's risk appetite, risk profile and market and macroeconomic conditions.

- Principle 24 – Liquidity risk:

The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both) for banks that reflect the liquidity needs of the bank. The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons. At least for internationally active banks, liquidity requirements are not lower than the applicable Basel standards.

- Principle 25 – Operational risk:

The supervisor determines that banks have an adequate operational risk management framework that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, assess, evaluate, monitor, report and control or mitigate operational risk on a timely basis.

- Principle 26 – Internal control and audit:

The supervisor determines that banks have adequate internal control frameworks to establish and maintain a properly controlled operating environment for the conduct of their business taking into account their risk profile. These include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

- Principle 27: Financial reporting and external audit:

The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function.

- Principle 28 – Disclosure and transparency:

The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies and corporate governance policies and processes.

- Principle 29 – Abuse of financial services:

The supervisor determines that banks have adequate policies and processes, including strict customer due diligence rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

These two sets of principles are among the standards the IMF focuses on in its Reports on the Observance of Standards and Codes,<sup>79</sup> and that the World Bank considers as part of its Financial Sector Assessment Program. How useful do you think the standards are?

In January 2010 the **Joint Forum** wrote:<sup>80</sup>

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

Applying the Basel and IOSCO principles can be complex due to the intricacies of domestic regulatory systems. As well as the issues of how responsibilities for different areas of financial regulation (securities, banking, insurance etc) may be split between different regulators within different national systems, different countries allocate responsibilities for banking supervision differently. In the US a number of different federal agencies currently have responsibilities in relation to banking regulation. The **Office of the Comptroller of the Currency (OCC)**<sup>81</sup> is the primary federal regulator for national banks.<sup>82</sup> The **Federal Reserve**

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<sup>79</sup> List of Standards, Codes and Principles Useful for Bank and Fund Operational Work and for which Reports on the Observance of Standards and Codes Are Produced at <http://www.imf.org/external/standards/scnew.htm> .

<sup>80</sup> Joint Forum, Review of the Differentiated Nature and Scope of Financial Regulation - Key Issues and Recommendations, 3 (Jan. 2010) at <http://www.bis.org/publ/joint24.htm>

<sup>81</sup> <http://www.occ.treas.gov> . The Dodd-Frank Act integrated the Office of Thrift Supervision into the OCC.

<sup>82</sup> In the US, banks may be chartered at the federal level as national banks or at the state level. This is the dual banking system (see below).

**Board** (Fed)<sup>83</sup> is the main federal regulator for state-chartered banks which are members of the Federal Reserve System, and the **FDIC** (Federal Deposit Insurance Corporation)<sup>84</sup> is the main federal regulator for state chartered banks which are not members of the Federal Reserve System. Often the federal banking regulators act together in proposing new federal banking regulations, and they are required to report to Congress on differences in their capital standards and accounting standards. The following excerpt is from the regulators' 2012 **Joint Report on Differences in Accounting and Capital Standards Among the Federal Banking Agencies**<sup>85</sup>

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 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. Although the differences in capital standards have diminished over time, a few differences remain, some of which are statutorily mandated.

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 been presented to only one agency. Agency staffs generally seek to minimize these occurrences by coordinating responses to the fullest extent reasonably practicable. Furthermore, while the agencies work together to adopt and apply generally uniform capital standards, there are wording differences in various provisions of the agencies' standards that largely date back to each agency's separate initial adoption of these standards before 1990.

The federal banking agencies have substantially similar capital adequacy standards. These standards are based on a common regulatory framework that establishes minimum leverage and risk-based capital ratios for depository institutions (banks and savings associations). The agencies view the leverage and risk-based capital requirements as minimum standards, and most institutions generally 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...

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<sup>83</sup> <http://www.federalreserve.gov/> .

<sup>84</sup> <http://www.fdic.gov/> .

<sup>85</sup> 77 Fed. Reg. 75259 (Dec. 19, 2012).

The risk-based capital rules of the Board assign a zero percent risk weight to claims collateralized by cash on deposit in the institution or by securities issued or guaranteed by U.S. Government agencies or the central governments of countries that are members of the Organization for Economic Cooperation and Development (OECD), provided there is daily mark-to-market of collateral and maintenance of a positive margin of collateral. The OCC rules with respect to national banks incorporate similar conditions for such collateralized claims eligible for a zero percent risk weight. However, while the Board's rules require such claims to be fully collateralized, the OCC's rules governing national banks permit partial collateralization.

Under the FDIC rules for state nonmember banks and the FDIC and OCC rules for state and federal savings associations, respectively, portions of claims collateralized by cash or by securities issued or guaranteed by OECD central governments or U.S. Government agencies receive a 20 percent risk weight. However, these institutions may assign a zero percent risk weight for claims on certain qualifying securities firms that are collateralized by cash on deposit in the institution or by securities issued or guaranteed by the U.S. Government, U.S. Government agencies, or other OECD central governments.... The risk-based capital rules of the Board and the FDIC and the capital regulations governing savings associations apply a 100 percent risk weight to equity securities of government-sponsored enterprises (GSEs). In contrast, the OCC's regulation governing national banks applies a 20 percent risk weight to all GSE equity securities.

Under the **International Banking Act**, a foreign bank which wants to do business in the US is required to obtain authorization to do so. If it wishes to establish a federal branch or agency it requires the approval of the OCC, if it wishes to establish a state branch, agency or representative office it requires the approval of the Federal Reserve. In practice, foreign banks doing business in the US have tended to establish state branches or agencies.<sup>86</sup>

## 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

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<sup>86</sup> See generally Foreign Banks and the Federal Reserve at <http://www.newyorkfed.org/aboutthefed/fedpoint/fed26.html> .

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.<sup>87</sup>

At the end of 2012 the Federal Reserve issued a notice of proposed rulemaking with respect to **Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies**<sup>88</sup>

The recent financial crisis demonstrated that certain U.S. financial companies had grown so large, leveraged, and interconnected that their failure could pose a threat to overall financial stability in the United States and globally. The financial crisis also demonstrated that large foreign banking organizations operating in the United States could pose similar financial stability risks. Further, the crisis revealed weaknesses in the existing framework for supervising, regulating, and resolving significant U.S. financial companies, including the U.S. operations of large foreign banking organizations. The Board recognizes the important role that foreign banking organizations play in the U.S. financial sector. The presence of foreign banking organizations in the United States has brought competitive and countercyclical benefits to U.S. markets. This preamble describes a set of proposed adjustments to the

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<sup>87</sup> You can access Regulation K at <http://www.federalreserve.gov/bankinforeg/reglisting.htm> .

<sup>88</sup> 77 Fed. Reg. 76627 (Dec. 28, 2012)

Board's regulation of the U.S. operations of foreign banking organizations to address risks posed by those entities and to implement the enhanced prudential standards and early remediation requirements in sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act). The proposed adjustments are consistent with the Board's long-standing policy of national treatment and equality of competitive opportunity between the U.S. operations of foreign banking organizations and U.S. banking firms.

The Board is responsible for the overall supervision and regulation of the U.S. operations of all foreign banking organizations. Other federal and state regulators are responsible for supervising and regulating certain parts of the U.S. operations of foreign banking organizations, such as branches, agencies, or bank and nonbank subsidiaries.

Under the current U.S. supervision framework for foreign banking organizations, supervisors monitor the individual legal entities of the U.S. operations of these companies, and the Federal Reserve aggregates information it receives through its own supervisory process and from other U.S. supervisors to form a view of the financial condition of the combined U.S. operations of the company. The Federal Reserve and other U.S. regulators also work with regulators in other national jurisdictions to help ensure that all internationally active banks operating in the United States are supervised in accordance with a consistent set of core capital and other prudential requirements. International standards are intended to address the risks posed by the consolidated organization and to help achieve global competitive equity. Under this approach, the Federal Reserve oversees operations in the United States, but also relies on the home country supervisor to supervise a foreign banking organization on a global basis consistent with international standards and relies on the foreign banking organization to support its U.S. operations under both normal and stressed conditions.

Under this regulatory and supervisory framework, foreign banking organizations have structured their U.S. operations in ways that promote maximum efficiency of capital and liquidity management at the consolidated level. Permissible U.S. structures for foreign banking organizations have included cross-border branching and holding direct and indirect bank and nonbank subsidiaries. U.S. banking law and regulation also allow well-managed and well-capitalized foreign banking organizations to conduct a wide range of bank and nonbank activities in the United States on conditions comparable to those applied to U.S. banking organizations. Further, as a general matter, a top-tier U.S. bank holding company subsidiary of a foreign banking organization that qualifies as a financial holding company has not been required to comply with the Board's capital standards since 2001 pursuant to Supervision and Regulation (SR) Letter 01-01.

As a result of this flexibility granted to foreign banking organizations in the United States, the current population of foreign banking organizations is structurally diverse. Some foreign banking organizations conduct U.S. banking activities directly through a branch or agency; others own U.S. depository institutions through a U.S.-based bank holding company; and still others own a U.S. depository institution directly. Most large foreign banking organizations also conduct a range of nonbank activities through separate nonbank subsidiaries. Similar to the largest, most complex U.S. banking organizations, some of the largest foreign banking organizations with operations in the United States maintain dozens of

separate U.S. legal entities, many of which are engaged in nonbank activities.

The structural diversity and consolidated management of capital and liquidity permitted under the current approach has facilitated cross-border banking and increased global flows of capital and liquidity.

However, the increase in concentration, complexity, and interconnectedness of the U.S. operations of foreign banking organizations and the financial stability lessons learned during the crisis have raised questions about the continued suitability of this approach. Additionally, the Congressional mandate included in the Dodd-Frank Act requires the Board to impose enhanced prudential standards on large foreign banking organizations. Congress also directed the Board to strengthen the capital standards applied to U.S. bank holding company subsidiaries of foreign banking organizations by adopting the so-called "Collins Amendment" to the Dodd-Frank Act. Specifically, section 171 of the Dodd-Frank Act requires a top-tier U.S. bank holding company subsidiary of a foreign banking organization that had relied on SR Letter 01-01 to meet the minimum capital requirements established for U.S. bank holding companies by July 21, 2015.

The following sections provide a description of changes in the U.S. activities of large foreign banking organizations during the period that preceded the financial crisis and the financial stability risks posed by the U.S. operations of these companies that motivate certain elements of this proposal.

#### Shifts in the U.S. Activities of Foreign Banking Organizations

Many of the core elements of the Federal Reserve's current approach to the supervision of foreign banking organizations were designed more than a decade ago, when the U.S. presence of foreign banking organizations was significantly less complex. Although foreign banking organizations expanded steadily in the United States during the 1970s, 1980s, and 1990s, their activities here posed limited risks to overall U.S. financial stability. Throughout this period, the U.S. operations of foreign banking organizations were largely net recipients of funding from their parent institutions and their activities were generally limited to traditional lending to home-country and U.S. clients.

The profile of foreign bank operations in the United States changed substantially in the period preceding the financial crisis. U.S. branches and agencies of foreign banking organizations as a group moved from a position of receiving funding from their parent organizations on a net basis in 1999 to providing significant funding to non-U.S. affiliates by the mid-2000s. In 2008, U.S. branches and agencies provided more than \$700 billion on a net basis to non-U.S. affiliates. As U.S. operations of foreign banking organizations received less funding, on net, from their parent companies over the past decade, they became more reliant on less stable, short-term U.S. dollar wholesale funding, contributing in some cases to a buildup in maturity mismatches. Trends in the global balance sheets of foreign banking organizations from this period reveal that short-term U.S. dollar funding raised in the United States was used to provide long-term U.S. dollar-denominated project and trade finance around the world as well as to finance non-U.S. affiliates' investments in U.S. dollar-denominated asset-backed securities. Because U.S. supervisors, as host authorities, have more limited access to timely information on the global operations of foreign banking organizations than to similar information on U.S.-based banking organizations, the totality of the risk profile of the U.S. operations of a foreign banking organization can be obscured when these U.S. entities fund activities outside the United States, such as occurred in

recent years.

In addition to funding vulnerabilities, the U.S. operations of foreign banking organizations have become increasingly concentrated, interconnected, and complex since the mid-1990s. Ten foreign banking organizations now account for roughly two-thirds of foreign banking organizations' third-party U.S. assets, up from 40 percent in 1995. Moreover, U.S. broker-dealer assets of large foreign banking organizations as a share of their third-party U.S. assets have grown rapidly since the mid-1990s. Five of the top-ten U.S. broker-dealers are currently owned by foreign banking organizations. In contrast, commercial and industrial lending originated by U.S. branches and agencies of foreign banking organizations as a share of their third-party U.S. liabilities dropped after 2003.

#### Financial Stability Risks Posed by U.S. Operations of Foreign Banking Organizations

The financial stability risks associated with the increased capital market activity and shift in funding practices of the U.S. operations of foreign banking organizations in the period preceding the financial crisis became apparent during and after the crisis. The large intra-firm cross-border flows that grew rapidly in the period leading up to the crisis created vulnerabilities for the U.S. operations of foreign banking organizations. While some foreign banking organizations were aided by their ability to move liquidity freely during the crisis, this model also created a degree of cross-currency funding risk and heavy reliance on swap markets that proved destabilizing. In many cases, foreign banking organizations that relied heavily on short-term U.S. dollar liabilities were forced to sell U.S. dollar assets and reduce lending rapidly when that funding source evaporated. This deleveraging imposed further stress on financial market participants, thereby compounding the risks to U.S. financial stability.

Although the United States did not experience a destabilizing failure of a foreign banking organization during the crisis, some foreign banking organizations required extraordinary support from home- and host-country central banks and governments. For example, the Federal Reserve provided considerable amounts of liquidity to both the U.S. branches and U.S. broker-dealer subsidiaries of foreign banking organizations during the financial crisis. While foreign banking organizations recently have reduced the scope and risk profile of their U.S. operations and have shown more stable funding patterns in response to these events, some have continued to face periodic funding and other stresses since the crisis. For example, as concerns about the euro zone rose in 2011, U.S. money market funds dramatically pulled back their lending to large euro-area banks, reducing lending to these firms by roughly \$200 billion over a four-month period.

#### Risks to Host Countries

Beyond the United States, events in the global financial community underscore the risks posed by the operations of large multinational banking organizations to host country financial sectors. The failure of several internationally active financial firms during the crisis revealed that the location of capital and liquidity is critical in a resolution. In some cases, capital and liquidity related to operations abroad were trapped at the home entity. For example, the Icelandic banks held significant deposits belonging to citizens and residents of other countries, who could not access their funds once those banks came under pressure. Actions by government authorities during the crisis period highlighted the fact that, while a foreign bank regulatory regime designed to accommodate centralized management of capital and

liquidity can promote efficiency during good times, it can also increase the chances of home and host jurisdictions placing restrictions on the cross-border movement of assets at the moment of a crisis, as local operations come under severe strain and repayment of local creditors is called into question. Resolution regimes and powers remain nationally based, complicating the resolution of firms with large cross-border operations.

In response to financial stability risks highlighted during the crisis and ongoing challenges associated with the resolution of large cross-border firms, several other national authorities have adopted modifications to or have considered proposals to modify their regulation of internationally active banks within their geographic boundaries. Modifications adopted or under consideration include increased requirements for liquidity to cover local operations of domestic and foreign banks and nonbanks, limits on intragroup exposures of domestic banks to foreign subsidiaries, and requirements to prioritize or segregate home country retail operations.

Actions by a home country to constrain a banking organization's ability to provide support to its foreign operations, as well as the diminished likelihood that home-country governments of large banking organizations would provide a backstop to their banks' foreign operations, have called into question one of the fundamental elements of the Board's current approach to supervising foreign banking organizations—the ability of the Board, as a host supervisor, to rely on a foreign banking organization to act as a source of strength to its U.S. operations when the foreign banking organization is under stress. The issues described above—growth over time in U.S. financial stability risks posed by foreign banking organizations individually and as a group, the need to minimize destabilizing pro-cyclical ring-fencing in a crisis, persistent impediments to effective cross-border resolution, and limitations on parent support—together underscore the need for enhancements to foreign bank regulation in the United States.

#### Overview of Statutory Requirements

Sections 165 and 166 of the Dodd-Frank Act direct the Board to impose a package of enhanced prudential standards on bank holding companies, including foreign banking organizations, with total consolidated assets of \$50 billion or more and nonbank financial companies the Financial Stability Oversight Council (Council) has designated for supervision by the Board (nonbank financial companies supervised by the Board). These stricter prudential standards for large U.S. bank holding companies, foreign banking organizations, and nonbank financial companies supervised by the Board required under section 165 of the Dodd-Frank Act must include enhanced risk-based capital and leverage requirements, enhanced liquidity requirements, enhanced risk management and risk committee requirements, resolution planning requirements, single-counterparty credit limits, stress test requirements, and a debt-to-equity limit for companies that the Council has determined pose a grave threat to financial stability.

Section 166 of the Dodd-Frank Act requires the Board to establish a regulatory framework for the early remediation of financial weaknesses for the same set of companies in order to minimize the probability that such companies will become insolvent and the potential harm of such insolvencies to the financial stability of the United States. Further, the Dodd-Frank Act authorizes, but does not require, the Board to establish additional enhanced prudential standards relating to contingent capital, public disclosures,

short-term debt limits, and such other prudential standards as the Board determines appropriate. The Dodd-Frank Act requires the enhanced prudential standards established by the Board under section 165 to be more stringent than those standards applicable to other bank holding companies and nonbank financial companies that do not present similar risks to U.S. financial stability. The standards must also increase in stringency based on the systemic footprint and risk characteristics of companies subject to section 165. Generally, the Board has authority under section 165 to tailor the application of the standards, including differentiating among companies subject to section 165 on an individual basis or by category. In applying section 165 to foreign banking organizations, the Act also directs the Board to give due regard to the principle of national treatment and equality of competitive opportunity and to take into account the extent to which the foreign banking organization is subject, on a consolidated basis, to home country standards that are comparable to those applied to financial companies in the United States. The Board has already issued proposed and final rules implementing certain elements of sections 165 and 166 of the Dodd-Frank Act. The Board and the FDIC jointly issued a final rule to implement the resolution plan requirement in section 165(d) of the Dodd-Frank Act for foreign and U.S. companies that became effective on November 30, 2011, and expect to implement periodic reporting of credit exposures at a later date. Section 165(d) establishes requirements that large foreign banking organizations, large U.S. bank holding companies, and nonbank companies supervised by the Board submit periodically to the Board and the FDIC a plan for rapid and orderly resolution under the U.S. Bankruptcy Code in the event of material financial distress or failure.

In December 2011, the Board proposed a set of enhanced prudential standards and early remediation requirements for U.S. bank holding companies with total consolidated assets of \$50 billion or more and U.S. nonbank financial companies supervised by the Board that included risk-based capital and leverage requirements, liquidity requirements, single-counterparty credit limits, overall risk management and risk committee requirements, stress test requirements, a debt-to-equity limit, and early remediation requirements (December 2011 proposal). On October 9, 2012, the Board issued a final rule implementing the supervisory and company-run stress testing requirements included in the December 2011 proposal for U.S. bank holding companies with total consolidated assets of \$50 billion or more and U.S. nonbank financial companies supervised by the Board. Concurrently, the Board issued a final rule implementing the company-run stress testing requirements for U.S. bank holding companies with total consolidated assets of more than \$10 billion but less than \$50 billion as well as state member banks and savings and loan holding companies with total consolidated assets of more than \$10 billion.

The proposed standards for foreign banking organizations are broadly consistent with the standards proposed for large U.S. bank holding companies and nonbank financial companies supervised by the Board in the December 2011 proposal. In general, differences between this proposal and the December 2011 proposal reflect the different regulatory framework and structure under which foreign banking organizations operate, and do not reflect potential modifications that may be made to the December 2011 proposal for U.S. bank holding companies. The Board is currently in the process of reviewing comments on the remaining standards in the December 2011 proposal and is considering modifications to the proposal in response to those comments. Comments on this proposal will help inform how the

enhanced prudential standards should be applied differently to foreign banking organizations.

The Board is requesting comment on proposed rules to implement the provisions of sections 165 and 166 of the Dodd-Frank Act for foreign banking organizations with total consolidated assets of \$50 billion or more and foreign nonbank financial companies supervised by the Board. The proposal includes: risk-based capital and leverage requirements, liquidity requirements, single-counterparty credit limits, overall risk management and risk committee requirements, stress test requirements, a debt-to-equity limit for companies that the Council has determined pose a grave threat to financial stability, and early remediation requirements. As described below, the Board is also proposing a supplemental enhanced standard: a requirement for certain foreign banking organizations to form a U.S. intermediate holding company, which would generally serve as a U.S. top-tier holding company for the U.S. subsidiaries of the company. The Board is not proposing any other enhanced prudential standards at this time, but continues to consider whether adopting any additional standards would be appropriate.

By setting forth comprehensive enhanced prudential standards and an early remediation framework for large foreign banking organizations, the proposal would create an integrated set of requirements that are intended to increase the resiliency of the U.S. operations of large foreign banking organizations and minimize damage to the U.S. financial system and the U.S. economy in the event such a company fails. The proposed rules, which increase in stringency with the level of systemic risk posed by and the risk characteristics of the U.S. operations of the company, would provide incentives for large foreign banking organizations to reduce the riskiness of their U.S. operations and to consider the costs that their failure or distress would impose on the U.S. financial system.

In applying section 165 to foreign banking organizations, the Act directs the Board to give due regard to the principle of national treatment and equality of competitive opportunity. As discussed above, the proposal broadly adopts the standards set forth in the December 2011 proposal to ensure equality of competitive opportunity, as modified appropriately for foreign banking organizations. Modifications address the fact that foreign banking organizations may operate in the United States through direct branches and agencies. The proposal also recognizes that not all foreign banking organizations that meet the statutory asset size thresholds, particularly those with a small U.S. presence, present the same level of risk to U.S. financial stability. As a result, the proposal would apply a reduced set of requirements to foreign banking organizations with combined U.S. assets of less than \$50 billion in light of the reduced risk that these companies pose to U.S. financial stability.

The Act also directs the Board in implementing section 165 to take into account the extent to which a foreign banking organization is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States. In developing the proposal, the Board has taken into account home country standards in balance with financial stability considerations and concerns about extraterritorial application of U.S. enhanced prudential standards. The proposed capital and stress testing standards rely on home country standards to a significant extent with respect to a foreign banking organization's U.S. branches and agencies because branches and agencies are not separate legal entities and are not required to hold capital separately from their parent organizations. In addition, the proposed risk management standards would provide flexibility for foreign banking

organizations to rely on home country governance structures to implement certain proposed risk management requirements.

The Dodd-Frank Act requires the Board to apply enhanced prudential standards to any foreign nonbank financial company supervised by the Board. Consistent with this statutory requirement, the proposal would also apply the enhanced prudential standards, other than the intermediate holding company requirement, to a foreign nonbank financial company supervised by the Board. In addition, the proposal would set forth the criteria that the Board would consider to determine whether a U.S. intermediate holding company should be established by a foreign nonbank financial company. The Board would expect to tailor the enhanced prudential standards to individual foreign nonbank financial companies, as necessary, upon designation by the Council.

A group of trade associations has asked for more time to react to the proposals (referring to “Proposed Rules of extraordinary complexity, with 306 pages of text and 103 questions.”<sup>89</sup>

The Proposed Rules are wide-ranging in scope, touching upon virtually every major area of prudential regulation, including risk-based capital and leverage requirements, liquidity standards, risk management, single-counterparty credit limits and stress-test requirements. They also are in important ways novel in their application, calling for far-reaching and unprecedented structural changes and introducing a totally new early remediation regime. Further, they have a very significant cross-border dimension and present potentially very profound implications for home-host country supervisory relationships. Their breadth and complexity call for both extensive analysis of the various individual requirements and the interrelationships among them and careful assessment of the extent to which they create an effective and cohesive framework for enhanced prudential supervision that is consistent with the Dodd-Frank Act and avoids unintended consequences. Moreover, due consideration must be given to the interaction of the Proposed Rules with other international financial reform initiatives, including in particular implementation of the Basel III Accord, as well as tax laws of close to 10 different jurisdictions. Finally, we anticipate that the evaluation of certain areas of the Proposed Rules (for example, the proposed liquidity and single-counterparty credit limit requirements) will constitute a very significant analytical exercise. This entire process is requiring an extensive commitment of time and personnel at a time when our members are also actively dealing with other significant implementation challenges under the Dodd-Frank Act...

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<sup>89</sup> See

[http://www.federalreserve.gov/SECRS/2013/February/20130204/R-1438/R-1438\\_013113\\_110956\\_52814\\_0603839\\_1.pdf](http://www.federalreserve.gov/SECRS/2013/February/20130204/R-1438/R-1438_013113_110956_52814_0603839_1.pdf)



**ARE BANKS DIFFERENT FROM OTHER FINANCIAL INSTITUTIONS ?**

Banks rely on other financial institutions to acquire credit risk from them by means of loan sales, loan participations and credit default swaps, and 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 2006, Marjorie Olson, then a Governor of the Federal Reserve Board,<sup>90</sup> argued that banks are special:<sup>91</sup>

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

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

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<sup>90</sup> Mark Olson was Chairman of the Public Company Accounting Oversight Board from 2006-9.

<sup>91</sup> See <http://www.bis.org/review/r060322c.pdf> .

**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<sup>92</sup> by Mark W. Olson** discusses whether dual banking regulation is a good thing or not:

Importance of the Dual Banking System...

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

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

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<sup>92</sup> <http://www.federalreserve.gov/boarddocs/speeches/2002/20020531/default.htm>

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**.<sup>93</sup>

...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

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<sup>93</sup> John D. Hawke, Jr., Comptroller of the Currency, Remarks at a Session on Banking Supervision with the People's Bank of China Beijing, China (Oct. 14, 2002) at <http://www.occ.gov/static/news-issuances/speeches/2002/pub-speech-2002-80.pdf>.

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 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.<sup>94</sup> 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

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<sup>94</sup> See, e.g., Advantages of a State Bank Charter [http://www.flofr.com/PDFs/state\\_charter.pdf](http://www.flofr.com/PDFs/state_charter.pdf) .



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.<sup>95</sup> Predatory lenders impose unfair terms on their customers. Where predatory loans are mortgage loans borrowers may lose their homes.<sup>96</sup> The statutes tend to be drafted to cover lending within the state rather than lending by state chartered banks. This makes some sense if borrowers cannot easily distinguish between state chartered and national banks and therefore cannot easily work out what rules would regulate predatory lending. However, national banks objected to being subjected to these state laws on the basis that they are pre-empted. A major concern underlying the objection was the impact of state predatory lending laws on securitizations. Rating agencies addressed these issues. For example, Standard & Poor's stated in 2003 that it considered whether predatory lending statutes provide for assignee liability, whether the loan categories affected are clearly defined, what penalties apply and how clear the statute is (including safe harbors). Rating

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<sup>95</sup> 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).

<sup>96</sup> 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.")

agencies and lenders suggested that if state statutes made it hard for lenders to securitize loans the legislation would be counter-productive and cut off access to credit for borrowers:

GAFLA, with its complicated structure, ambiguous provisions and undefined terms, has created uncertainty, and the secondary market has reacted strongly and negatively. The reaction was to be expected on 'high cost' loans, as the large, national buyers of home loans such as Fannie Mae and Freddie Mac do not buy those loans. However, the market has also reacted negatively to 'covered' loans primarily due to the uncertainty created by the wording of the Act. No other state or federal anti-predatory lending laws include a category of mid-priced loans in their statutes, and loans made in Georgia will continue to be treated with suspicion by the secondary market. The national buyers of mortgage loans have changed their underwriting standards and now require lenders to agree to take back any loans made under GAFLA if a compliance failure is found – even years after the loan was closed, sold or even paid off.<sup>97</sup>

In January 2004 the OCC issued two rules: one on Bank Activities and Operations; Real Estate Lending and Appraisals<sup>98</sup> and the other on Bank Activities and Operations.<sup>99</sup> These rules attempt to delineate when state rules may impact national banks and when they may not.

In **Watters v. Wachovia Bank**<sup>100</sup> 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

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<sup>97</sup> The Georgia Bankers Association White Paper, Georgia Fair Lending Act. The Unintended Consequences 5 (Jan. 2003).

<sup>98</sup> 69 Fed. Reg. 1904 (Jan 13, 2004).

<sup>99</sup> 69 Fed. Reg 1895 (Jan 13, 2004).

<sup>100</sup> 550 U.S. 1 (2007).

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 in which the subsidiary operates.

Wachovia Bank is a national banking association chartered by OCC. Respondent Wachovia Mortgage is a North Carolina corporation that engages in the business of real estate lending in the State of Michigan and elsewhere. Michigan's statutory regime exempts banks, both national and state, from state mortgage lending regulation, but requires mortgage brokers, lenders, and servicers that are subsidiaries of national banks to register with the State's Office of Financial and Insurance Services (OFIS) and submit to state supervision. From 1997 until 2003, Wachovia Mortgage was registered with OFIS to engage in mortgage lending. As a registrant, Wachovia Mortgage was required, inter alia, to pay an annual operating fee, file an annual report, and open its books and records to inspection by OFIS examiners.

Petitioner Linda Watters, the commissioner of OFIS, administers the State's lending laws. She exercises "general supervision and control" over registered lenders, and has authority to conduct examinations and investigations and to enforce requirements against registrants. She also has authority to investigate consumer complaints and take enforcement action if she finds that a complaint is not "being adequately pursued by the appropriate federal regulatory authority."

On January 1, 2003, Wachovia Mortgage became a wholly owned operating subsidiary of Wachovia Bank. Three months later, Wachovia Mortgage advised the State of Michigan that it was surrendering its mortgage lending registration. Because it had become an operating subsidiary of a national bank, Wachovia Mortgage maintained, Michigan's registration and inspection requirements were preempted. Watters responded with a letter advising Wachovia Mortgage that it would no longer be authorized to conduct mortgage lending activities in Michigan.

Wachovia Mortgage and Wachovia Bank filed suit against Watters, in her official capacity as commissioner, in the United States District Court for the Western District of Michigan. They sought declaratory and injunctive relief prohibiting Watters from enforcing Michigan's registration prescriptions against Wachovia Mortgage, and from interfering with OCC's exclusive visitorial authority. The NBA and regulations promulgated thereunder, they urged, vest supervisory authority in OCC and preempt the

application of the state-law controls at issue. Specifically, Wachovia Mortgage and Wachovia Bank challenged as preempted certain provisions of two Michigan statutes--the Mortgage Brokers, Lenders, and Services Licensing Act and the Secondary Mortgage Loan Act. The challenged provisions (1) require mortgage lenders--including national bank operating subsidiaries but not national banks themselves--to register and pay fees to the State before they may conduct banking activities in Michigan, and authorize the commissioner to deny or revoke registrations, (2) require submission of annual financial statements to the commissioner and retention of certain documents in a particular format, (3) grant the commissioner inspection and enforcement authority over registrants, and (4) authorize the commissioner to take regulatory or enforcement actions against covered lenders.

In response, Watters argued that, because Wachovia Mortgage was not itself a national bank, the challenged Michigan controls were applicable and were not preempted. She also contended that the Tenth Amendment to the Constitution of the United States prohibits OCC's exclusive superintendence of national bank lending activities conducted through operating subsidiaries.....

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

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

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

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

"Any national banking association may make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate, subject to 1828(o) of this title and such restrictions and

requirements as the Comptroller of the Currency may prescribe by regulation or order."

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

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

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

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

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

In 1999, Congress defined and regulated "financial" subsidiaries; simultaneously, Congress

distinguished those national bank affiliates from subsidiaries--typed "operating subsidiaries" by OCC--which may engage only in activities national banks may engage in directly, "subject to the same terms and conditions that govern the conduct of such activities by national banks." Gramm-Leach-Bliley Act (GLBA).. For supervisory purposes, OCC treats national banks and their operating subsidiaries as a single economic enterprise. OCC oversees both entities by reference to "business line," applying the same controls whether banking "activities are conducted directly or through an operating subsidiary." As earlier noted, Watters does not contest the authority of national banks to do business through operating subsidiaries. Nor does she dispute OCC's authority to supervise and regulate operating subsidiaries in the same manner as national banks. Still, Watters seeks to impose state regulation on operating subsidiaries over and above regulation undertaken by OCC. But just as duplicative state examination, supervision, and regulation would significantly burden mortgage lending when engaged in by national banks, so too would those state controls interfere with that same activity when engaged in by an operating subsidiary.

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

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

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

Second, Watters ignores the distinctions Congress recognized among "affiliates." The NBA broadly defines the term "affiliate" to include "any corporation" controlled by a national bank, including a

subsidiary. An operating subsidiary is therefore one type of "affiliate." But unlike affiliates that may engage in functions not authorized by the NBA, e.g., financial subsidiaries, an operating subsidiary is tightly tied to its parent by the specification that it may engage only in "the business of banking" as authorized by the Act. Notably, when Congress amended the NBA confirming that operating subsidiaries may "engag[e] solely in activities that national banks are permitted to engage in directly," it did so in an Act, the GLBA, providing that other affiliates, authorized to engage in nonbanking financial activities, e.g., securities and insurance, are subject to state regulation in connection with those activities. Recognizing the necessary consequence of national banks' authority to engage in mortgage lending through an operating subsidiary "subject to the same terms and conditions that govern the conduct of such activities by national banks," OCC promulgated 12 CFR § 7.4006 (2006): "Unless otherwise provided by Federal law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank." Watters disputes the authority of OCC to promulgate this regulation and contends that, because preemption is a legal question for determination by courts, § 7.4006 should attract no deference. This argument is beside the point, for under our interpretation of the statute, the level of deference owed to the regulation is an academic question. Section 7.4006 merely clarifies and confirms what the NBA already conveys: A national bank has the power to engage in real estate lending through an operating subsidiary, subject to the same terms and conditions that govern the national bank itself; that power cannot be significantly impaired or impeded by state law.

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

In **Cuomo v. Clearing House Association**<sup>101</sup> the Supreme Court distinguished between the exercise of visitorial powers (which was pre-empted by the NBA) and judicial enforcement actions brought by the Attorney General. Justice Scalia wrote:

Historically, the sovereign's right of visitation over corporations paralleled the right of the church to supervise its institutions and the right of the founder of a charitable institution "to see that [his] property

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<sup>101</sup> 129 S. Ct. 2710 (2009).

[was] rightly employed," .. By extension of this principle, "[t]he king [was] by law the visitor of all civil corporations," A visitor could inspect and control the visited institution at will.

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

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

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

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

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

Our most recent decision, Watters v. Wachovia Bank does not, as the dissent contends "support[t] OCC's construction of the statute." To the contrary, it is fully in accord with the well established distinction between supervision and law enforcement. Watters held that a State may not exercise "general supervision and control" over a subsidiary of a national bank because "multiple audits and surveillance under rival oversight regimes" would cause uncertainty " [G]eneral supervision and control" and "oversight" are worlds apart from law enforcement. All parties to the case agreed that Michigan's general oversight could not be imposed on national banks; the sole question was whether operating



subsidiaries of national banks enjoyed the same immunity from state visitation. The opinion addresses and answers no other question.

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

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

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

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

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

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

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

On a pragmatic level, the difference between visitation and law enforcement is clear. If a State chooses to pursue enforcement of its laws in court, then it is not exercising its power of visitation and will be treated like a litigant. An attorney general acting as a civil litigant must file a lawsuit, survive a motion to dismiss, endure the rules of procedure and discovery, and risk sanctions if his claim is frivolous or his

discovery tactics abusive. Judges are trusted to prevent "fishing expeditions" or an undirected rummaging through bank books and records for evidence of some unknown wrongdoing. In New York, civil discovery is far more limited than the full range of "visitorial powers" that may be exercised by a sovereign. Courts may enter protective orders to prevent "unreasonable annoyance, expense, embarrassment, disadvantage, or other prejudice." A visitor, by contrast, may inspect books and records at any time for any or no reason.

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

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

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

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

The dissent fails to persuade us. Its fundamental contention--that the exclusive grant of visitorial powers can be interpreted to preclude state enforcement of state laws--rests upon a logical fallacy. The dissent establishes,.. (and we do not at all contest), that in the course of exercising visitation powers the sovereign can compel compliance with the law. But it concludes from that that any sovereign attempt to

compel compliance with the law can be deemed an exercise of the visitation power. That conclusion obviously does not follow. For example, in the course of exercising its visitation powers, the sovereign can assuredly compel a bank to honor obligations that are in default. Does that mean that the sovereign's taking the same action in executing a civil judgment for payment of those obligations can be considered an exercise of the visitation power? Of course not. Many things can be compelled through the visitation power that can be compelled through the exercise of other sovereign power as well. The critical question is not what is being compelled, but what sovereign power has been invoked to compel it. And the power to enforce the law exists separate and apart from the power of visitation.

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

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

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

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

When, however, a state attorney general brings suit to enforce state law against a national bank, he is

not acting in the role of sovereign-as-supervisor, but rather in the role of sovereign-as-law-enforcer. Such a lawsuit is not an exercise of "visitorial powers" and thus the Comptroller erred by extending the definition of "visitorial powers" to include "prosecuting enforcement actions" in state courts .. The request for information in the present case was stated to be "in lieu of" other action; implicit was the threat that if the request was not voluntarily honored, that other action would be taken. All parties have assumed, and we agree, that if the threatened action would have been unlawful the request-cum-threat could be enjoined. Here the threatened action was not the bringing of a civil suit, or the obtaining of a judicial search warrant based on probable cause, but rather the Attorney General's issuance of subpoena on his own authority under New York Executive Law, which permits such subpoenas in connection with his investigation of "repeated fraudulent or illegal acts . . . in the carrying on, conducting or transaction of business." See N. Y. Exec. Law Ann. § 63(12) (West 2002). That is not the exercise of the power of law enforcement "vested in the courts of justice" which 12 U.S.C. § 484(a) exempts from the ban on exercise of supervisory power. Accordingly, the injunction below is affirmed as applied to the threatened issuance of executive subpoenas by the Attorney General for the State of New York, but vacated insofar as it prohibits the Attorney General from bringing judicial enforcement actions.

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

**Julie Williams of the OCC** stated in a speech in 2004:<sup>102</sup>

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

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<sup>102</sup> Julie Williams left the OCC in 2012.

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.<sup>103</sup>

## CAPITAL ADEQUACY (AN 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<sup>104</sup> 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

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<sup>103</sup> Julie L. Williams, Chief Counsel and First Senior Deputy Comptroller, Office of the Comptroller of the Currency, *National Banks and Uniform Standards*, Remarks to America's Community Bankers Government Affairs Conference (Mar.9, 2004 ) available at <http://www.occ.gov/static/news-issuances/news-releases/2004/nr-occ-2004-18a.pdf>.

<sup>104</sup> Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

by securities issued by such banks; (b) Claims on banks incorporated in the OECD and claims guaranteed by OECD incorporated banks; (c) Claims on securities firms incorporated in the OECD subject to comparable supervisory and regulatory arrangements, including in particular risk-based capital requirements, and claims guaranteed by these securities firms; (d) Claims on banks incorporated in countries outside the OECD with a residual maturity of up to one year and claims with a residual maturity of up to one year guaranteed by banks incorporated in countries outside the OECD; (e) Claims on non-domestic OECD public-sector entities, excluding central government, and claims guaranteed by or collateralised by securities issued by such entities; (f) Cash items in process of collection

**50%** : (a) Loans fully secured by mortgage on residential property that is or will be occupied by the borrower or that is rented

**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.”<sup>105</sup>
- 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.

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<sup>105</sup> Andrew Crockett

**Basel II**<sup>106</sup>

Basel II focuses on:

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

**1. Minimum Capital Requirements****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.

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<sup>106</sup> <http://www.bis.org/publ/bcbsca.htm> .

Basel II encouraged 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)

Basel II 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**

Basel II 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.

**Basel III** was developed in response to the financial crisis. An outline of the reforms is available at <http://www.bis.org/bcbs/basel3/b3summarytable.pdf> .