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Creating an EU Level Supervisor for Cross-Border Banking Groups:

Issues Raised by the U.S. Experience with Dual Banking*

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1- Introduction and motivation

The European Union (EU) has been facilitating the growth of cross-border banking groups with considerable success, but bank supervision remains the responsibility of national supervisors. The difficulties this poses have been vividly highlighted by the problems encountered in the present crisis and the costs for taxpayers and creditors and the moral hazard have been increased as a result. The conundrum has long been recognized and various proposals have been offered to address this weakness, ranging from full centralization of prudential supervision (Pratti and Schinasi, 1999) to ad hoc cooperation via colleges (Mayes, Nieto and Wall 2008). While full centralization of supervision lacks political support there is a variety of ways in which the key issues can be tackled effectively with only partial centralization. In this paper we analyse the creation of an EU banking charter for cross-border groups supervised by an

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EU-level agency. Other banks would continue to be chartered and supervised by the national supervisors.[1]

Other regions have already faced the issue of cross-border banking supervision. For example, a banking system in the EU with charters issued by two levels of agencies would roughly parallel the United States dual bank chartering system (often referred to as simply dual banking in the U.S.) that allows banks to choose between charters issued by the federal government and charters issued by the state government. In previous work on this issue, Čihák and Decressin (2007) have also addressed the question of an EU charter. However, they propose an EU charter and EU prudential rules but leavie open the question of the structure of the prudential supervisor including the possibility that EU chartered banks would be supervised by national authorities. Along similar lines, Hertig, Lee and McCahery (2009) propose that Member states will have the option to delegate the supervision of banks that pose EU wide prudential risks to the ECB under an opt-in approach. The opting in process would require a Member state to enter into a binding agreement with the ECB, which would spell out coordination and cooperation in normal times as well as in periods of crisis, and which may also contain Member state specific provisions. In the U.S. a bank's choice of charter determines its choice of bank supervisor(s).

The U.S. experience suggests that a system seeking to maintain dual charters will generate a variety of issues that should be addressed by policymakers. The purpose of this paper

[1] The issues raised in this paper for the EU would also apply to the creation of an international bank supervisor responsible for the supervision of cross-border banking groups around the world. The principal difference is that most of the issues discussed in this paper would be even more difficult to resolve absent a global body with the authority comparable to that exercised by the EU in most of Europe.

is to identify some of the major issues that U.S. policymakers have faced with its system of dual banking and consider their implications should the EU decide to proceed with an EU level charter and supervisory authority for its cross-border banking groups. The main issues are as follows: (a) the criteria for eligibility to the EU charter and the possibility of arbitrage between charters; (b) who would take responsibility for providing the safety net and (c) the interaction between the dual charter and the national business conduct regulation.

We do not advocate for or against Europe's adoption of the U.S. policies on any of the various issues. Arguably the U.S. seems to have adopted the "right" answers to some issues and the "wrong" issues to some other problems. But U.S. policies have been tailored to the U.S. political and financial systems as they have evolved through time. What the U.S. experience can do is help to identify the more important issues and demonstrate some of the consequences of some possible solutions.

The rest of the paper is organized as follows: Section 1 briefly reviews the origin of the US dual banking system in contrast with the EU institutional framework for supervision. The regulatory issues raised by the dual charter are analyzed in section 2,, where we explore what could be the criteria for eligibility for an EU charter and the chartering authority; whether some or all banks that qualify for an EU charter be required to convert to an EU charter and under what circumstances could a bank with an EU charter be allowed to convert back to a national charter. The issues raised by the lack of an EU-level safety net are also analyzed in this section that explores alternatives that would return control over their fiscal exposure to the member states. Lastly, this section discusses issues associated with preemption in the business conduct regulation. We conclude and present policy implications in the last section.

1. Background

The creation of an EU level supervisor for cross-border banks[2] has become a somewhat more attractive solution to the supervision of these banks in the EU in the light of the experiences in the autumn of 2008. The concern is not simply that some authority should have supervisory control over the group as a whole with a mandate to protect the financial stability of each country in which the group operates but that it should have the information, tools and powers to act should any problem be detected. Such a system would allow for continued differences in the supervision of groups that are, at most, of systemic importance to their home country while focusing a new EU level supervisory agency on the cross-border banking groups. However, the creation of such a dual supervisory system at national and EU levels would also raise a number of new issues. Among these issues are a set of concerns relating to the relationship between the two levels of supervisors (agencies), and with investor protection regulators (whether a separated agency or not of the prudential supervisor); how the two levels of supervisors would work with the agencies running the safety net — the deposit insurers and lenders of last resort.[3] Clearly unless the EU-level agency were in charge of systemic concerns for every part of the EU there is a major problem of coordination with the national agencies that have that task. Furthermore given the absence of any noticeable ability to make fiscal transfers

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[2] The cross-border banks we are referring to are those where at least one host country regards its operations as being of systemic importance, i.e. its failure would be a threat to financial stability.

[3] We deal here with the more tractable proposition of banks that are headquartered and operating in the EU/EEA. If banks are headquartered further afield or have major activities elsewhere the problem will remain difficult to handle without a supranational agency in charge and probably still so then as there is so little alignment of international bank insolvency legislation.

and other adjustments that would ease the impact of regional shocks as in the US, the need for treating localized financial instability directly in the EU is much greater than in the present US.

In contrast to proposals that the EU deliberately adopt a dual chartering system (Čihák and Decressin (2007); Hertig, Lee and McCahery (2009)), the U.S. dual banking system was an unintended consequence of the creation of the National Banking System in 1863 to help fund the Union effort in the U.S. Civil War by increasing demand for government bonds.[4] The federal charter was not created to facilitate interstate banking; the legal changes to facilitate widespread interstate commercial banking were not adopted until the 1980s. Nor was the federal charter created to better control safety net subsidies. The modern U.S. lender of last resort was created by legislation passed in 1913 and the U.S. deposit insurance system was created by legislation passed in 1933. Instead of the federal charter being created to facilitate change, it is much more the case that these important changes to the U.S. commercial banking regulatory and safety net systems were structured to work within a dual chartering system.

The differences in the origin of dual chartering have important implications for EU policymakers should they adopt a dual chartering system. These differences do not relate to the issues that must be addressed but the order may have important implications for the resolution of some issues. Rather than cross-border banking and safety net policies being developed in consideration of the prior existence of dual chartering as in the U.S., the EU would need to develop its dual chartering and supervisory policies in the light of existing supervisory and safety net structures.

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

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

2.1 Who is subject to EU level supervision?

While virtually all banks and thrifts in the U.S. are subject to one of the federal supervisors, all that a U.S. bank needs to change its supervisor is permission from its new supervisor. A bank may change between a federal and a state charter. If a bank has a state charter, it may chose between being a member of the Federal Reserve System or being a state chartered bank that is Federal Deposit Insurance Corporation (FDIC) insured but not a member of the Federal Reserve.[5] Insured depositories with a thrift charter that are supervised by the Office of Thrift Supervision (OTS) may switch to a commercial bank charter from the federal or state government, and banks may convert to thrifts (albeit portfolio restrictions may apply). The complexity of regulatory authorities in the US, among thrifts, housing finance entities, the OCC, the Federal reserve and other non-bank financial institutions is not something one could imagine Europe wishing to emulate and indeed the US is itself discussing simplifying it. Our concern is simply with the idea of a single EU-level supervisory authority in addition to the national authorities. We address in a separate paper (Mayes et al, 2010) whether it might not make more sense to have an Eu-level deposit insurer rather than simply a supervisor, as it is in the resolution of difficulty rather than in on-going supervision that the greater problem arises.

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[5] Most, if not all, U.S. states require federal deposit insurance as a condition for obtaining a state charter. Thus, banks generally cannot avoid some form of federal supervision. There are some limits on the ability of banking institutions to change supervisors. All companies that own a commercial bank are classified as bank holding companies (BHCs) or financial holding companies (FHCs). All BHCs and FHCs are subject to regulation by the Federal Reserve, albeit the Federal Reserve generally relies on the bank's primary federal supervisor for its assessment of the individual holding company's banks. However, if the commercial bank switches to a thrift charter, then its holding company is supervised by the OTS.

This ability of banks to change their charters is regarded by most banks as a critical part of the U.S. dual banking system. One of the advantages claimed for this approach is that it discourages unnecessarily restrictive regulation. Indeed, those who praise the dual banking system for encouraging innovation generally are thinking of cases where the state supervisors denied banks permission to engage in a new activity which was authorized by the federal supervisors (or vice versa with state supervisors approving the activity). Another advantage is that it puts pressure on supervisors to be efficient. State supervisors and the national bank and thrift supervisors depend on fees collected from their banks to fund their operations.[6] If banks start changing charters that raises the revenue of the supervisor gaining the charter and lowers the revenue of the supervisor losing the charter.

Conversely, opponents of the dual banking system accuse it of promoting competition in laxity. As noted earlier, Wilmarth (2204) argues that the OCC has tried to get state chartered banks to adopt a national charter by promoting its ability to preempt stricter state business conduct regulation. Appelbaum and Nakashima (2008) discuss how the OTS's efforts to increase the agency's revenues by expanding its set of regulatees led to weak prudential supervision.[7] In one particular case, Countrywide, the OTS induced a national bank regulated by the OCC to change to a federal thrift charter with the added consequence of the OTS taking over holding company supervision from the Federal Reserve. Appelbaum and Nakashima (2008) quote a former

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[6] National banks are supervised by the Office of the Comptroller of the Currency (OCC) and federally chartered thrifts are supervised by the OTS. The FDIC and Federal Reserve do not charge fees but depend on other sources of income.

[7] Appelbaum and Nakashima (2008) article available at http://www.washingtonpost.com/wp-dyn/content/article/2008/11/22/AR2008112202213_pf.html

Countrywide executive as saying "The general attitude was they (the OTS) were going to be more lenient."

In theory national supervisors in the EU could compete for national bank charters under current legal framework only subject to the requirement of minimum harmonization imposed by the Banking Directive. Under the “single passport” concept, a bank that is properly authorized in any EU country may branch into any other EU country. Moreover, the rules governing the branches in host countries are determined by the safety regulations of the bank’s home country. In principal, a bank that found its home country supervisors too strict, it could move its charter to a more accommodating country, provided that the change was approved by the bank’s new home country. Indeed, in theory the degree of regulatory competition in the EU could be far greater than among states in the U.S. While banks in the U.S. can change supervisors, virtually all U.S. banks have to comply with federal laws and regulations. In contrast, in the EU it is not only possible to change supervisors but also to change to a new legal code (subject only to EU harmonization of minimum standards in certain areas).

In practice, moving charters is not so easy in the EU. While banking laws may not prohibit movements, a variety of other considerations such as taxes, deposit insurance payments and the franchise value greatly raise the cost of transferring charters. However, the disadvantages of having an EU-level supervisor do not rest on the existence of competition. Nevertheless, unless an EU-level supervisor offered clear examples of lower compliance costs, banks might structure themselves so as to qualify for continuing national supervision.

The creation of an EU charter and supervisor raises three questions: (1) What are the criteria for eligibility for an EU charter? (2) Will some or all banks that qualify for an EU charter be required to convert to an EU charter? (3) Who will be the chartering authority? And, (4) Under what circumstances, if any, will a bank with an EU charter be allowed to convert back to a national charter? The answers to these questions will determine the extent of competition and possibilities of arbitrage between national and EU level supervisors.

The criteria for eligibility for an EU charter could be subjective (such as national supervisors' assessments of systemic importance) or objective (such as market share or size). [8] The simplest objective criterion would be to allow all banks to obtain an EU charter. However, this open ended criterion would go far beyond addressing the current problem of how to regulate cross-border groups. A narrower set of criteria would start with the extent to which the bank has cross-border operations. Another consideration may also include the absolute size of the group as a proxy for its importance to the EU. A third consideration would be the number (and possibly size) of the countries in which the group is systemically important as per the decision made by the college of supervisors.

Once the various EU chartering criteria are satisfied, the question arises as to whether conversion to an EU charter would be mandatory and who would be the chartering authority. If the goal of creating an EU level supervisor is to address the problems of supervising and resolving cross-border groups better, the answer would appear to be that some groups would be required to convert to the EU charter. If conversion is not mandatory, regulatory competition is likely if groups have a choice as to whether to adopt an EU charter.

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[8] The Obama administration's proposal for non-depository financial firms to be labeled a Tier 1 Financial Holding Company and subject to Federal Reserve regulation provides several subjective criteria and leaves the ultimate decision to the Federal Reserve. While such an approach is theoretically possible for the EU, in practice it seems likely to create conflicts between member states and the EU authority that determines eligibility.

Once cross border banking groups have taken an EU charter, a further question is whether they would be allowed to convert back to national charters. The answer to this question may seem obvious if some institutions are required to convert to an EU charter, they obviously would not be given permission to convert back to a national charter. However, consider the case where the group no longer satisfies the criteria for an EU charter. A group may no longer meet the criteria because of a deliberate decision to sell or spin off part of its operations. Or it may be that the group is shrinking relative to the requirements for an EU charter. Were any of these to happen, should the group be required to retain an EU charter, required to convert to a national charter or given the option to convert back to a national charter? If conversion back to a national charter is envisioned, the provision for conversion back to a national charter should include some criteria that would limit frequent charter switches.[9]

2.2 Who is responsible for providing the safety net?

The U.S. did not have an official lender of last resort or national deposit insurance system at the start of the dual banking system.[10] However, commercial-bank clearinghouses in some major cities provided a sort of lender of last resort and accompanied it with some bank supervision from the 1850s through to the creation of the Federal Reserve according to Gorton and Mullineaux (1987). While clearinghouses were valuable in mitigating the impact of bank panics,

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[9] Examples of such rules are requiring that the group not just fail the minimum criteria for an EU charter but that it must fail the criteria by a substantial margin. For example, if the minimum asset size to obtain an EU charter is 500 billion Euros, a bank could convert back to a national charter only if its assets fell below 400 billion euros. Another way to prevent frequent switches would be to require that the bank fail the criteria for more than multiple years before being allowed to convert back to a national charter.

[10] Calomiris (1989) notes that three states insurance programmes predated the National Banking Act continued in operation until 1865 or 1866.

they in effect required private institutions to provide a public good in the form of reduced financial instability. After the Panic of 1907, some major New York banks determined that the private costs of providing this public good exceeded these banks' share of the gains according to Moen and Tallman (2003). With added support from New York bankers after the Panic of 1907, a central bank was created in the U.S. with the passage of the Federal Reserve Act of 1913. The Federal Reserve Act provided for the new central bank to lend on good collateral to its member banks. The Act required national banks to become members. The Act also allowed state chartered members to become members of the Federal Reserve, but required as a condition of membership that state-chartered member banks (state member banks) submit to Federal Reserve supervision, including on-site examinations.[11]

Deposit insurance during the dual banking era initially took the form of state run deposit insurance systems adopted by eight states in the early 1900s according to Calomiris (1989). All eight of these state plans were exclusively for banks chartered by that state. All eight of these systems collapsed with the waves of bank failures in the 1920s and early 1930s.[12] Federal deposit insurance started with the creation of the Federal Deposit Insurance Corporation (FDIC) by the Banking Act of 1933. That Act required Federal Reserve member banks (national and state

[11] The all or nothing bargain offered to state chartered banks also included other benefits and costs for joining the Federal Reserve. The benefits included access to the Federal Reserve's nationwide payments system at zero marginal cost. The costs of membership included a requirement to hold non-interest bearing reserves at their regional Federal Reserve Bank. Over the last several decades, there have been changes to both the costs and benefits of Federal Reserve membership. The ability to borrow from the discount window and the obligation created by reserve requirements have been extended to all banks. Additionally, the Federal Reserve may (and currently does) pay interest on reserves.

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

member) to join the FDIC. State non-member banks, that is banks which had not been subject to inspection by federal bank supervisors, were authorized to join the FDIC but only after examination and approval by the FDIC.[13] The FDIC had no enforcement power for the first 20 months of its life after accepting a bank. However, the Banking Act of 1935 gave the FDIC the power to terminate a bank's insured status.[14] This was a draconian penalty that, when invoked, would typically result in the bank's closure.

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

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

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[13] FDIC A History of the FDIC 1933-1983. Chapter 3. http://www.fdic.gov/bank/analytical/firstfifty/chapter3.pdf .

[14] Chapter 6 of FDIC History - http://www.fdic.gov/bank/analytical/firstfifty/chapter6.html

collateral is acceptable.[15] While the FDIC is not the primary supervisor of national banks or state chartered, Federal Reserve member banks, the FDIC does have backup authority to examine these institutions.[16]

In the EU, while it may be possible to create an EU level prudential supervisor for cross-border banking groups, responsibility for safety net provision will almost surely remain a national responsibility for the foreseeable future. The primary difficulty in shifting safety net responsibility to the EU is that the EU lacks taxing authority; that power remains lodged in its member states. The lack of backing by a fiscal authority can be a problem for a central bank according to Buiter (2008) as the collateral they take for their loans may turn out to be worth less than the value of their loans.[17] He notes that while individual member states stand behind their national central bank, no fiscal authority stands behind the ECB. However, the national central banks are the shareholders of the ECB and should they need to subscribe more capital they can call on their respective governments. The problem is even more immediate for deposit insurance agencies. Even agencies that have accumulated an ex ante fund may find the funds are inadequate during peak loss periods, as has happened in the U.S. with the Federal Savings and Loan Insurance Corporation (FSLIC) and may happen with the FDIC during the current global financial crisis. However, contingent funding from member states could be set up pending replenishment of the fund by the industry after the crisis.More difficult would be covering the

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[15] 12 Code of Federal Regulation 201. http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=de1a245501fa2479f877eb5242fbcf65&rgn=div5&view=text&node=12:2.0.1.1.2&idno=12#12:2.0.1.1.2.0.1.3

[16] **Risk Assessment: Results of an International Survey of Deposit Insurers** by Jane F. Coburn and John P. O'Keefe--**2003 Volume 15, No. 1 --h**ttp://www.fdic.gov/bank/analytical/banking/2003apr/article2.html

[17] http://www.cepr.org/pubs/PolicyInsights/PolicyInsight24.pdf

sort of bailout financing that has been used in some countries in the present crisis. In future other forms of contingent capital emanating from the dreditors could be used (Wall, 2009).

Thus, the creation of an EU level supervisor threatens to create a situation where the member state providers of the safety net do not have direct control over parts of their loss exposure. The potential problems with this are both economic and political. The economic problem is that of a principal (the voters and taxpayers of a member state) that has no direct control over that of an agent. In practical terms, this means that an EU level prudential supervisor may assign lower priority to minimizing taxpayer losses than would be the case if the supervisor were accountable to the taxpayers of the responsible country through that country's political system. The political problem is that the lack of a fully binding ex ante commitment on the part of the national governments to provide funding as necessary. The voters and taxpayers of a country may refuse to bear the burdens of cleaning up a large financial crisis over which neither they nor their elected representatives had any control. Such a refusal is more likely to the extent that the EU level supervisor is perceived to have failed to adequately perform its supervisory duties. In the present crisis where there have been cross-border spillovers there have been no outright refusals to pay, although there has been a vigorous dispute over terms in the case of Iceland. However, this has been in the context of national authorities, where one country would end up facing the consequences if the others refused to participate. In the EU-level case there is still an incentive for the affected countries to avoid a systemic crisis irrespective of blame.

One alternative that would return control over their fiscal exposure to the member states would be to adopt the approach taken by the Federal Reserve and FDIC with regards to banks they do not directly supervise. That is, give the NCB and national deposit insurers the authority to: (1) request additional information, (2) undertake their own backup examinations, and (3) where appropriate to deny the loan or terminate the insurance coverage.[18] This is not a perfect solution from the perspective of the national safety net authorities or the EU level supervisor. The national safety net authorities are still somewhat dependent upon the EU level supervisor to alert them when a cross-border banking groups encounters financial problems. However, from the EU supervisor's perspective, alerting national safety net authorities could be problematic. The problem is that the national authorities could take actions (such as starting proceedings to terminate deposit insurance of a distressed bank) that could aggravate a bank's problems at a time when the EU level supervisor believes it still has a good chance of returning to health.

Without such backup powers, the situation is in largely ways analogous to the current situation where the member states' are exposed to losses arising from banks and banking groups over which they have little or no supervisory power.

2.3 Business Conduct Regulation

The United States has had a long running dispute over the ability of its states to impose business conduct regulation on federally chartered financial firms. U.S. federal courts have generally held that business conduct regulation of federally charted depositories (commercial banks and thrifts) is the exclusive province of the federal government, in U.S. terms that federal law preempts state

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

law.[19] However, state and local governments have periodically sought to enforce their conduct regulations when they perceive federal rules to be too weak or inadequately enforced. [20]

This presents a problem that does not exist in the EU at present. While cross-border banks operating directly or through branches are subject to home country prudential control they are subject to host country conduct of business rules. It is not clear that there is any need for this to change in the EU purely because of the creation of an EU-level prudential regulator. It is a different question whether an n+1th conduct of business regime should be created in order to improve the ease of entry into markets. We therefore explore the experience of the US to consider the relative advantages of doing this.

One of the rationales for federal banking law preempting state banking law is that states might otherwise impose laws that put federally chartered banks at a competitive disadvantage.[21] Another rationale for federal preemption is that change in state laws or their interpretations may

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

[20] Most recently, the debate in the U.S. has been reenergized by the Obama administration's proposal to revise the regulation of financial products in the U.S. The administration proposes to strength business conduct regulation both by the creation of a new federal agency and by explicitly allowing states to impose and enforce state laws where those laws are tougher than federal standards.

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

impose losses on the federal safety net.[22] A third rational for preemption is that state business conduct regulation may be used to limit competition in that state. [23]

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

The opponents of preemption tend to favor the approach proposed by the Obama administration under which federal business conduct regulations set minimum standards for federally chartered banks but states should have the option of writing and enforcing tougher standards. Consumers Union (1998) gave a list of state measures intended to " protect … constituents from unfair

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[22] The supreme court of the state of California ruled that the enforcement of certain loan terms was "unconscionable" under California law in certain circumstances according to Mason and Singer (2009). The effect of this decision and similar changes in the laws of other states would have been to impose significant losses on federally chartered savings and loans according to Mason and Singer (2009). In order to prevent this decision from having an adverse impact on federally chartered thrifts, the Federal Home Loan Bank Board preempted the state laws. The U.S. Supreme Court upheld the preemption in Fidelity Fed. S. & L. v. De la Cuesta. 458 U.S. 141 (1982).

[23] For example, Mason and Singer (2009) note a Massachusetts law that allowed a non-Massachusetts bank to set up at ATM in Massachusetts only if that Massachusetts banks could set up an ATM in that state. However, even where the laws are clearly intended to benefit consumers, their anticompetitive impact may actually be adverse to consumers. As an example, Mason and Singer (2009) point to municipal ordinances in San Francisco and Santa Monica that banned banks from charging ATM fees to customers of other banks. Such regulations reduce the charges to consumers when they are able to access an ATM owned by another bank. However, these laws also have the effect of limiting consumers' access to ATMs, both by encouraging banks to limit ATMs to their own customers and by discouraging banks from placing ATMs in new locations.

banking practices and escalating fees" that were rendered less effective and in some cases effectively blocked by federal preemption.[24] Similarly, Fisher (2005) gives three examples of cases where national bank subsidiaries engaged in "predatory lending" due to inadequate enforcement by the OCC.

Another argument that opponents of preemption make is that allowing federally chartered institutions to avoid state regulation may undercut states ability to enforce consumer regulations on state chartered institutions. In part this argument arises because the federal chartering authorities are competing to attract existing and potential future state chartered institutions to adopt federal charters. The federal authorities may make the federal charter relatively more attractive by implementing less strict regulations. Indeed, Wilmarth (2004) references comments by then Comptroller of the Currency Hawke as touting the OCC's ability to preempt state consumer laws as one of the advantages of adopting a national bank charter.[25] Moreover, the competitive advantages of being able to preempt state law can be so large that a large fraction of the business shifted to federally chartered banks. For example, Furletti (2004) discusses the impact of preemption on the U.S. credit card industry and argues that it helped national banks become by far the largest suppliers of credit cards in the U.S.[26]

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[24] This list of state measures highlights a key philosophical difference between most advocates of preemption and most its opponents. Opponents of preemption tend to view strict government regulation as necessary to protect consumers from making mistakes. In contrast, advocates of preemption tend to view competition as providing the best combination of services and prices to consumers in the long-run. Many of the supporters of preemption would view the Consumer Union's list as providing examples where preemption was beneficial.

Consumer Union report at http://www.consumersunion.org/finance/9171rptdc798.htm

[25] SSRN link to Wilmarth - http://papers.ssrn.com/sol3/papers.cfm?abstract_id=577863

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

The issues associated with preemption in the EU are generally similar to those in the U.S. National authorities might use business conduct regulation to disadvantage EU chartered banks, while EU supervisory authorities may use preemption to give their banks a competitive advantage. National authorities may establish laws that both “protect consumers from abuses” and “limit competition.” Preemption may be praised or criticized for reversing the effect of national regulations. Occasionally changes in national business conduct rules may have adverse consequences for the financial stability of EU chartered bank groups. Compliance with national business conduct regulations will reduce the efficiency of EU chartered banking groups.

The weighting of the various advantages and disadvantages of preemption in the EU may differ from that of the U.S. in at least two important ways. First, there are greater differences across the EU in culture and commercial codes than within the U.S. The U.S. does not have a uniform culture nor do all states have exactly the same commercial code. However, the shared history of the states of the U.S. and state efforts to produce a recommended “Uniform Commercial Code” have greatly reduce the differences across the states relative to that of the member states of the EU. These cultural and legal differences across the EU likely extend to some aspects of some financial products. Arguably, business conduct rules appropriate for Italy may not be so appropriate for Finland and vice versa. One implication of this is that investors’ expectations of the rules may differ dramatically implying a greater value to local rules. Another implication is that independent of business conduct rules, cross-border banks in the EU will need

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

to tailor their offerings more to local markets than is necessary in the U.S. — probably reducing the efficiency advantages of a single framework for business conduct.

On the other hand, the EU is unlike the U.S. in that it has an explicit goal of a single market in financial services across its member states and, hence minimum harmonization also holds for business conduct rules. Allowing member states to impose differential rules on cross-border groups will hinder movement towards that goal. Indeed, even the harmonization process is not a complete substitute for a imposing a single rule book on cross-border banking groups. Even if every Member State has a law designed to accomplish a given goal, these laws are unlikely to be transposed and interpreted in exactly the same manner. Thus, a bank operating in multiple countries would continue to need to conform to the differences in that law in each member state rather than adopting uniform procedures across all of its banks and branches. Clearly the opportunity to get round the heterogeneity of rules for what are likely to be the largest banks would act as a major force for harmonization.

3. Conclusions and policy implications for the EU

The idea of having an EU-level prudential supervisor for cross-border banks in addition to national supervisors for the rest of the system has considerable attractions. It addresses the issue of having a consistent arrangement for the regulation and supervision of such groups. Moreover, if the Eu-level supervisor also applies a single set of rules rather than simply trying to ensure that the plethora of national rules are applied and reconciled if they conflict, this could result in considerable simplification and reduction in compliance costs if it is efficiently provided. Thus this is likely to prove a more elegant solution than the colleges of supervisors approach that is currently envisaged.

However, it has the disadvantage that two sets of rules are being applied in one member state. But this is not new. Branches of banks registered in other member states are already operating under their home country prudential rules, in principle, meaning that up to 27 sets of rules could be operating. In practice the number is much smaller, at least for significant banks. We look to the US for evidence on the experience with a dual banking system with two levels of regulator. Here the experienced is somewhat mixed as while regulatory competition may encourage regulators to be efficient in order to attract banks it may also encourage them to be lax or set lower standards. The experience of the present crisis makes this an unpopular prospect and a race for quality would be more attractive than a race for the bottom. The US experience suggests this is quite a difficult incentive structure to put in place. It should occur through ratings and their impact on the cost of borrowing, making prudence a virtue.

A further drawback when the safety net has to be invoked. In the US the safety net is at federal level through the FDIC. Solving this analogously for the EU would involve a second EU-level agency unless the supervisor were also the insurer. Solving it indirectly involves agreements among agencies and the opportunity for insurers to be unwilling to pay out or national authorities to fund if they view the problem to be the fault of the EU-level agency. We deal with ways of tackling this in a separate paper (Mayes et al, 2010).

One aspect of the dual mandate which the Eu would be well-advised not to emulate is conduct of business regulation. The EU is slowly harmonizing conduct of business regulation subject to minimum standards. While cross-border banks would be keen to see a single set of rules and providing such rules would no doubt accelerate the process of harmonization this is not something that is key to financial stability and was not emphasized as a problem in the present crisis. It could therefore continue on the present track and thereby keep any duplication of regulation and supervision to a minimum.

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