The Increasing Integration and Competition of Financial Institutions and of Financial Regulation

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Abstract

Deregulation and other factors permit and encourage financial institutions to become more integrated, both within their own (financial) industries, such as banking and insurance, and across those industries. Financial regulators have responded with like integration. As financial institutions increasingly compete with firms from other industries and areas, financial regulators similarly compete more across borders. The resulting competition in financial regulation enhances innovation, choice, and efficiency. The advent of home run regulation, which in general allows financial institutions to adhere only to the financial regulations of their home area and is spreading across the US and Europe, may allow numerous regulatory regimes within a given market.

Keywords: Federal preemption, home-run regulation, financial regulation, dual banking, Riegle-Neal, uniform markets, regulatory competition.

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Both the real and the financial sides of the world economy became considerably more integrated and less regulated over the past three decades. Over the same period, the operations and structures of financial institutions and of their regulation have changed greatly and rapidly. Even so, the actual evolutions and revolutions in the financial sector have often not been able to match the forecasts for them.[1] Though the extent and speed of change in the financial sector may have often fallen short of consensus forecasts, nonetheless, many more financial services have come to be supplied by individually-more-integrated financial institutions. While it remains to be seen whether the oft-foretold era of the financial supermarket has finally arrived, both financial institutions and financial regulation have become more integrated in recent years.[2]

As financial (de-) regulation has proceeded worldwide for the past three decades, financial institutions, especially the larger ones, have expanded the ranges of the products and services they offer and the geographical areas over which they offer them. That deregulation has spurred increasing competition between banks and also between banks and nonbank financial institutions. It has similarly sharpened competition between all financial institutions across political borders.

Just as financial institutions seek, subject to their regulation, their optimal scales and scopes, so too do financial regulators. As financial institutions have become more (horizontally) integrated, in recent years so too have their regulators. The Financial Services Authority (FSA) in UK now oversees the firms of several financial industries. Other advanced countries have also integrated their various financial regulators into

single regulatory agencies. Though the US has not yet integrated them, its several financial regulators each now regulate financial institutions that have expanded the scopes of their operations. Thus, for example, the Federal Reserve System now inspects newly-authorized, wide-ranging financial holding companies. Similarly, the US Office of the Comptroller of the Currency (OCC) regulates commercial banks and their subsidiaries that now face fewer restrictions on the products and services that they can offer.

That same deregulation brought with it increased competition between regulators of the same type of financial institutions (e.g., banks) that have different home bases (US states or countries) and between regulators of different types of financial institutions (banks and insurance companies from either the same or different home bases).

While it may often be difficult to identify which event or action by a financial institution or regulator initially served as a stimulus, the volleying of actions and reactions of financial institutions and their regulation can often readily be identified. In some cases, technological advances in telecommunications or computing or macroeconomic events--such as high nominal interest rates, likely served as the stimuli. Responses by financial institutions were then volleyed by their regulators, often in the form of loosened regulations. These replies often led to further adjustments by financial institutions and subsequent adjustments by financial regulators. These adjustments included not just offerings of new financial products and services, but also included the basic restructuring of the financial institutions and of financial regulators themselves.

Section I below points out some of the factors that have propelled the increasing integration of and competition between financial institutions. Section I also points out

how and why financial regulations should and have responded in kind—by becoming more integrated and competing more. Section II describes the aspects of the financial systems of the US and Europe that already offer alternative regulators to financial institutions. Section III notes some of the recent market and regulatory developments that illustrate the continuing shifts that are associated with competition between financial institutions and between financial regulators. Section IV then analyzes a number of the benefits that are associated with competition in financial regulation. It concludes with a delineation of the prior and the novel aspects of those benefits. Section V draws together these perspectives and indicates what might be next for financial regulations and thus for the financial institutions that they regulate.

I. Integration of the World Economy and Financial institutions and Their Regulation

This section identifies some of the principal factors that have propelled the increasing integration of and competition between financial institutions. It also points out why and how financial regulations have responded in kind, that is by also becoming more integrated and competing more.

A number of factors have contributed importantly to these developments over the past three decades. Both the real and the financial sides of the world economy have become much more integrated. Stocks and flows of real and financial assets across (and probably within) national borders have grown enormously for the past decade and, indeed, for the past half century. Financial markets have been deregulated to varying degrees all over the world. Financial institutions are now less constrained in their products and services, prices, and locations.

Many large, sophisticated, liberalized financial sectors were liberalized even further and entire nations' stultified financial systems were reconfigured and reconstructed following various, very large shocks, such as the demise of the Soviet Union, financial crises, hyperinflations, and so on. Technological advances in the telecommunications and computing industries were widespread and rapid. They in turn fostered further technical advances in finance. The combination of these advances significantly reduced the costs of conducting and combining many financial activities. As a consequence, financial institutions have become increasingly integrated across (financial) activities and across geographical (or political) borders. To regulate firms with greater diversities, or scopes, of products and services, regulators have similarly integrated, in that more and more activities are under the purview of fewer regulatory bodies.

The same forces that elicited greater scopes in the offerings of products and services by financial institutions have also elicited greater geographical areas over which firms can efficiently operate. Restrictions that impeded US banks from operating across state borders and European banks from operating across national borders have both been whittled down. In connection with the resulting increases in cross-border competition between firms, competition across borders in financial regulation has also intensified.

We refer to the ability of state-chartered banks in the US and banks of European Union (EU) member states to answer, generally, to only the financial regulations of their home states as "home run regulation." Like dual banking in the US and more specifically its modern reincarnation under the 1997 amendments to the Riegle-Neal Act, home country control in the EU may be described as home run regulation. In the EU home run

regulation permits each banking institution's branches, operating side-by-side with host-country bank branches in a given EU member country (e.g., in Britain), to operate subject largely to the regulations of its home country (e.g., those of Britain, Spain, and potentially up to fifteen, and soon twenty-five, countries). Home run regulation creates competition in regulation, since financial institutions directly and their customers indirectly via their choices of financial institutions in a given geographical area can choose which of two (or more) sets of regulations will pertain to them.

Some circumstances suggest that, rather than having home run regulation with a myriad of choices of regulators, there are benefits to having financial regulations be imposed uniformly across borders. The Tiebout perspective suggests that regulatory authority should devolve to the smallest unit that internalizes externalities.[3] That perspective posits a trade-off between the benefits of local variations in regulations and the costs of localities' not sufficiently internalizing the costs of the externalities associated with local regulations.[4]

The spate of bank and thrift failures in the US illustrated how expensive it was, and might be again, not to internalize competitive and safety-net-related externalities associated with regulatory competition. Thus, at the same time that competition in financial regulation increased in some spheres, it has been harnessed or eliminated in other spheres. A result of the failures in the US was that some financial regulation then came under the purview of the federal government and thus, in effect, pertained to all US banks and thrifts.

International agreement on the Basel Accord effectively shifted some regulation, such as that of capital, from a national to a supranational body. The growth of cross-

border competition between financial institutions over the past generation made the externalities associated with their operations even more apparent. One impetus to the Basel Accord of the late 1980s and its presumed revision after 2005 has been that differential regulation tilted the competition between firms. Moving toward more uniform standards may have also tilted the global financial system away from systemic risks.

The original Tiebout formulation related to geographically oriented regulation. As we shall see below, in the financial sectors of the US and of Europe, an important aspect of regulatory competition may also occur within a given geographic area, such as a US state or an EU member state. While such regulatory competition is hardly new to the US, it has come only more recently to the EU. In the US, for well over a century, banks in a given area have had the option of being regulated by either a local (i.e., state) or a federal agency. Now, within the EU, generally, banks can operate abroad while generally being subject only to home run regulation.

II. Home Run Regulation in the US and in Europe

Financial regulation may be almost completely centralized at the national (i.e., federal in the US) level or may be almost entirely local.[5] These extreme cases, the intermediate cases between them, and variations that permit simultaneous operation of both extremes can have benefits and costs that differ considerably. Among the factors that would likely affect assessments about each case are its benefits and costs of tailoring of regulations to local preferences, of fostering laboratories for private and public experimentation, of costs imposed on businesses and customers of operating across localities, of restrictions on entry and competition, and of the stabilizing effects of cross-locality financial operations.

Among the alternatives to the extreme cases are (1) voluntary cooperation that seeks to minimize some variations of regulations across the borders of US states or EU member states and (2) "mixed" systems, wherein different government entities charter financial institutions to operate side-by-side in a given geographical area under different sets of regulations. The longstanding dual banking system in the US is an example of a mixed system where an agency of the federal government charters and regulates "national" banks, while simultaneously localities (agencies of state governments) charter and regulate "state" banks.

Below, we describe and discuss how the US dual banking system has operated in the past. We also address the newer, US and European analog that may supplant dual banking regulation—home run regulation.

Home run regulation has now emerged as a potentially powerful new force in the financial sectors of the US and Europe. The 1997 amendments to the Riegle-Neal Act permit, with respect to some aspects of interstate banking and branching, state chartered banks to operate some interstate banking and branching operations under the regulations of their chartering state while being exempt host state regulations.[6] Similarly, the EU has developed mixed systems of financial regulation where, within some broad guidelines, financial institutions (including banks, insurance companies, etc.) from one country may operate in other countries under their home country regulations, while remaining largely exempt (at least for specified activities) from the regulations of the host country.

A. Dual Banking in the US

In the US, state and national banks can operate side-by-side in a given geographical area. They operate under overlapping, but importantly (actually or

potentially) distinct sets of regulations. Thus, state banks have long been able to operate independently of the regulations that were designed for national banks, and vice versa. That provided banks and their customers in effect with a choice of operating under a state or a national bank charter. (Some bank holding companies even owned some banks that were state and some banks that were nationally chartered.) Having a dual banking system requires that the regulations that apply to state and national banks do, or at least can, differ somewhat.

A "pure" dual banking system might subject state banks only to state regulations. Analogously, national banks would be subject solely to regulations for national banks and not to states' financial regulations. Past and current versions of dual banking in the US differ markedly from this "pure" form of dual banking. The regulations that apply to each bank charter have historically been far from completely distinct. In practice, state banks are subject to federal banking regulations (as opposed to those promulgated for national banks) and national banks are subject to some state regulations.

In addition, and consistent with the federal form of government in the US, both national and state banks, large and small, local and interstate, are in effect subject to various federal banking regulations and regulators. For example, although federal deposit insurance technically may be voluntary, in practice, virtually all banks provide it for their customers. Further, national banks must be members of the Federal Reserve System and many state banks, especially the larger ones, also choose to be members. As a result, nearly all state banks are also subject to the regulations of either the FDIC or the Federal Reserve System.

Additional aspects of dual banking in the US extend the effective reach of the regulator of national banks. For example, the vast majority of states have more or less complete "parity or wild card" laws that grant their state banks the same powers as national banks and that exempt their state banks from restrictions and costs that may not be binding on national banks. Such parity laws may be interpreted as attempts by states to protect the competitiveness of state banks and state bank charters.

Similarly, some state regulations do apply to national banks. National banks are subject to state laws for non-banking matters such as contract law, criminal law, torts, zoning, etc. (OCC 2004). In addition, although courts routinely rule that state laws that conflict with federal laws (and federal regulations that apply those laws) do not apply to national banks, Congress can "federalize" state law by making state laws on specific topics applicable to national banks. For instance, the Glass-Steagall Act, which was enacted in 1933, decreed that national banks would have the branching rights that were available to state banks in that jurisdiction (Rose 1989).

Occasionally, the federalization of state laws may take place through "opt outs" and "opt ins". The Riegle-Neal Act, formally known as the Interstate Banking and Branching Efficiency Act (IBBEA) of 1994, established a federal default under which (1) bank holding companies (BHCs) may acquire existing banks across state lines and (2) BHCs and banks may not open *de novo* banks and branches across state lines. However, the Act also provided that states may pass legislation (applicable to national banks) to "opt out" of interstate banking and/or to "opt in" into interstate branching. As a "penalty" for opting out, however, the law required that the BHCs that were headquartered in states that opted out could not engage in the acquisition of out-state banks. In addition, without

any federal penalty, states may have legislation to permit, restrict, or forbid *de novo* interstate banking and branching by both state and national banks (Calem and Nakamura 1998: 600). Thus, the US dual banking system has not entailed completely distinct regulations for state and national banks.

B. Home Country Control in the EU

In the 1980s, the EU (actually, its predecessor, the European Community) launched the "Single Market" program to remove barriers to the free movement of goods, persons, services (including financial services), and capital among its member states. In banking and finance, the Second Banking Directive (1989), along with other EU legislation, greatly eased the entry of banks from one EU country into the others and established a mixed regulatory system for EU banking.

EU banking legislation now provides a framework of minimum requirements (capital requirements, deposit insurance, etc.) that have to be met by banks headquartered in any EU country and a list of permissible activities for EU banks. This list is rather comprehensive by the standards of US commercial banks. The list includes deposit taking, lending (consumer, commercial, mortgage, etc.), leasing, credit cards, investment banking, portfolio management, derivatives trading, and several other activities (European Union 2004). Each EU country may permit, regulate, restrict, or forbid the activities included in that list (and other activities not included in that list) for banks headquartered within its territory. However, a country may neither (1) restrict the establishment of branches of banks headquartered in other EU countries, nor (2) prevent those branches from carrying out activities that are included in that list if they are permitted in the country where they are headquartered. Thus, Britain may restrict British

commercial banks from engaging in investment banking, but it may not prevent the branches of a Spanish commercial bank in Britain from engaging in investment banking, if that activity is permitted in Spain.

Further, EU banking law seeks to minimize the numbers of laws and regulators that banks operating outside of their country need to deal with. Under the principle of home country control, a bank's branches outside of their home country are largely supervised by the bank's home country regulator and not by those of the host countries.[7] However, each host country still retains the right to forbid and restrict activities not included in the list of permissible activities for EU banks.

The US approach to home run regulation differs somewhat from that of the EU. One notable difference is in charter choice. Although EU bank consumers may, in effect, change laws and regulators by using the local branches of a bank headquartered in different EU country, EU banks themselves are restricted in their ability to change, or "flip," charters in that they would have to move their headquarters to another country or merge with a foreign bank.

Another difference involves the use of mixed regulation outside of depository institutions. In the US, mixed regulation is largely restricted to depository institutions (e.g., commercial banks, thrifts, and credit unions). In the EU, home run regulation (in the form of home country control) applies to a broader array of financial services and institutions. For instance, home run regulation applies to insurance and securities institutions. The list of activities of EU banks that fall under home run regulation includes a broad range of activities (investment banking, etc.) for which home run regulation does not apply in the US.

Similarly, the ongoing project for an EU business charter (Societas Europaea) shows how European regulatory practices may both retrace earlier US paths and point toward venues for expanding dual chartering in the US. The EU business charter would permit businesses that operate across more than one European country to operate under a single European charter and under (something closer to) a single regulatory environment. This project retraces earlier American paths by introducing an EU charter that is not linked to any member country (akin to the national bank charter in the US). The EU charter departs from US tradition since the charter would not be limited to commercial banking, but would be open to other areas of business activity. The European example raises the issue of whether the benefits of home run regulation justify its being extended beyond banking, for instance to the insurance or securities industries in the US.

III. Charter Changes and Changes of Charters

Competition in financial regulation requires that firms have some choice of the regulations that will pertain to them. Over time, the "market shares" of financial institutions, assets, or activities that are under the aegis of each of the financial regulations inevitably shift. The ratio of state banks to total bank assets will change over time as certain banks grow disproportionately and as banks flip from one charter to another in order to change the body of regulation that will pertain to them. Some shifts in market shares will be transient, while others will be more longstanding and perhaps continual. In evaluating the future prospects for a given set of regulations, it will often be crucial to distinguish between these types of shifts and responding effectively will often require identifying the sources of the shifts.

In the case of the US dual banking system, the balance can and does vary through time for various reasons. Changing in general or specific market conditions, in banks' strategies, in banks' leadership, and other factors may lead enough banks or large banks with enough assets to change charters and thereby change noticeably the numerical balance between state and national banks and assets. Changes in the numerical balance may also occur over time as a result of changes in the relative opportunities and constraints associated with state and national charters. As one charter's regulations prove increasingly attractive, the balance ought to shift noticeably toward that charter. The resulting regulatory competition provides banks and their customers with incentives to prefer certain charters and banks.

Periodically, changes in the regulation of state or national banks may noticeably alter market shares for the two charters. For example, the 1994 Riegle-Neal Act and the 1997 amendments to Riegle-Neal may have each ultimately importantly affected (in opposite directions, however) the average ratio of total bank assets that were in state banks. Each regulation on its own may have shifted the balance, or equilibrium ratio, but neither may have set off a continual slide in market shares. Since a bank's changing its charter is not undertaken lightly or quickly, attaining new equilibrium levels may take years. Thus, while a change from one equilibrium level of a market share to another may look like a continuing decline, the apparent trend may only be the manifestation of a multi-year adjustment to a new, sustainable balance between two (or more) viable charters.

The ratio of state to total bank assets may change as one charter adapts more quickly to changed circumstances. When large changes occur, either in one of the

charters or in the banks of the economies in which they operate, large incentives arise for that charter to innovate in order to enhance its charter and thereby recover some or its entire lost market share. Thus, even large shifts of assets toward one charter at the expense of the other charter may not signal that either is imperiled. In addition, even now, if one of the largest US banks changes its charter, it may noticeably alter market shares.

History and logic indicate that if one charter becomes far more attractive than the other, the other charter is the more likely to react. The less pressing the crisis is, the less the charter reacts; the more likely is doom, the larger is the response. The 1997 amendments to the Riegle-Neal Act can be seen in this light. While the Riegle-Neal Act might have shifted the balance toward the national charter, the 1997 amendments, which allowed state banks to adhere to the regulations of the state of their headquarters, were designed to attenuate that shift.

IV. Benefits of Competition in Financial Regulation

This section specifically addresses the benefits of competition in regulation the US dual banking system. The benefits, however, would generally accrue to the EU version and to other versions of home run regulation in other financial industries.

A. Overview

Consumers and policymakers have long recognized the benefits of competition among firms: Enhanced innovation, choice, and efficiency. Competing firms have incentives to produce new and better products and services for their customers. Competing firms offer customers choices among firms and among products and services. Competing firms strive to operate more efficiently in order to attract more customers with lower prices.

The US dual banking system provides an example of how financial regulation can also benefit from competition. Dual banking allows banks to choose between state and national charters, which entail different laws, regulations, and regulators.[8]

This section describes how competition in financial regulation benefits banks, their customers, and local and national economies by enhancing innovation, choice, and efficiency in bank activities and regulation. Some recent studies and trade associations argue that competition in regulation would provide benefits to other financial industries, such as insurance, as well.

The remainder of this section proceeds as follows. Section B describes how competition in financial regulation enhances innovation. Banks and their regulators have powerful economic incentives to mimic others' successful innovations. Vibrant competition between charters encourages both innovations that can at least temporarily differentiate charters and ensuing adaptations that restore their similarities. Section C describes how competition in financial regulation enhances choice. Section D describes how competition in financial regulation enhances efficiency. By providing the option of national regulation, dual banking facilitates uniform national markets. National regulation reduces costs for banks that operate across state lines and for their customers, streamlines interstate bank transactions, eases entry by and sharpens competition from out-of-state banks, cushions downturns in local and regional economies, and helps channel funds to areas that offer the greatest benefits to borrowers and the greatest rewards to savers and thereby raises national production and wealth. By providing the option of state regulation, dual banking facilitates state bank regulations that are tailored to local conditions. Competition in financial regulation also spurs regulatory efficiency and stability. Section

E discusses the critical role of preemption in sustaining competition in financial regulation. Section F describes how competition in financial regulation has been extended beyond US banking to the banking, insurance, and securities industries in the EU. Section G summarizes the benefits of competition in financial regulation.

B. Competition Enhances Innovation

1. Dual banking encourages innovation

The state and national components of the US dual banking system serve as "laboratories" for innovations both in bank products and services and in public policies. These laboratories consist of state banks and their regulators in each of the 50 states and the District of Columbia as well as national banks and the national bank regulator, the OCC. These numerous laboratories, innovating largely independently of one another, can simultaneously test a wide range of bank products and services and public policies. States differ considerably in their sizes, in their current economic conditions, in their average per capita incomes, and in the relative importance to their economies of manufacturing, financial services, tourism and entertainment, agriculture, international trade, and other sectors. As a result, these statewide laboratories can provide information about how various innovations perform under widely differing conditions.

An advantage of the US dual banking system is that it provides a venue for innovations small and large. Since there are far more state bank regulators and state banks, innovations are likely to be more numerous in the state component of the dual banking system. In contrast, innovations by national banks and their regulator are likely to be fewer in number but national, and thus larger, in scale. While many innovations in bank products and services and in bank regulation may have costs and benefits that are

justified even in quite small markets, some innovations may have sufficiently large development or implementation costs that only a large, multistate market would justify incurring those costs.

Just as all innovation involves risk, so, too, does failing to innovate. When technology and economic conditions change rapidly, opportunities for successful innovation are the greatest. So, too, are the benefits of shedding outdated and inefficient practices and regulations.

The dual banking system has a built-in shock absorber for innovations that work less well. An innovation in one part of the US dual banking system, for example an innovation in the bank activities permitted by one state bank regulator, won't be adopted universally and instantly elsewhere. For a time, then, a significant share, and very often an overwhelming share, of banks won't participate in the innovation. The non-participating banks then serve as shock absorbers when innovations are less successful. Thus, adverse repercussions on customers, banks, and economies of less successful innovations at the state level are limited by having national banks. Similarly, the adverse repercussions of less successful national innovations are limited by having state banks in every state that did not participate in the innovation. Thus, the dual banking system provides incentives to innovate and opportunities to benefit from innovations, while simultaneously mitigating the risks associated with innovations.

2. Dual banking transmits more innovations more rapidly

In addition to encouraging innovations, the dual banking system provides banks and their regulators with powerful economic incentives to mimic others' successful innovations. A successful innovation by state banks (or their regulator) in one state likely

tilts the competition in favor of the state banks at the expense of national banks in that state. National banks are then likely to prod the OCC to permit (or adopt) that innovation. If the OCC determines that the innovation sufficiently maintains national banks' safety and soundness, it may permit (or adopt) that innovation, thereby providing national banks in all states with access to the innovation. As a consequence, state banks in other states would likely prod their own regulators to follow suit, so that they can compete effectively with the national banks in their own states. In this way, dual banking transmits more successful innovations more rapidly to state and national banks that do not compete directly with the state bank or state regulator that initiated the innovation.

3. Vibrant competition spurs charters to be similar

The permissible activities and regulatory costs of state and national banks need not differ persistently for the dual banking system to be competitive and healthy. During periods of large or rapid changes in technologies, economic conditions, or financial developments, innovations in activities and costs may produce noticeable differences across bank charters. Historically, innovations like checking accounts, in-state branching, interest-bearing checkable deposits, and adjustable rate mortgages all originated in state banks. As each succeeded, it spread to other states and to national banks. More recently, innovations like insurance sales, discount securities brokerage, and real estate brokerage have been spreading across the banking system.

Vibrant competition between the state and national charters whittles away at the differences across charters via the most sincere form of flattery – imitation.[9] A key then to a vibrant dual banking system is not how different the two kinds of charters are at any point in time, but, rather, how readily successful innovations are diffused throughout both

the state and national bank systems. In that regard, then, the similarity of charters signals the vigor of the competition between national and state charters.

The narrow bands within which the shares of state banks and state bank assets fluctuated over the past century attest to the balance between state and national charters. State banks comprised 71 percent of all commercial banks in 1900, 65 percent in 1950 and 74 percent in 2003 (when there were circa 5,800 state banks and circa 2,000 national banks). State banks' shares of bank assets fluctuated within an even narrower band. State bank assets comprised 45 percent of all commercial bank assets in 1900, 43 percent in 1950, and 44 percent in 2003.

C. Competition Enhances Choice

Competition between the national and state bank regulators in each state enhances the choices available to banks and their customers. The previous section noted that successful innovations are diffused as time passes, thereby simultaneously increasing the choices of banks and their customers and increasing the similarities of state and national charters. Before an innovation has spread far, however, charters may differ enough that bank customers can recognize differences in bank regulations. For instance, after a state charter first permitted ARMs but before the national charter did, customers readily noticed the difference in mortgage offerings. Typically, however, bank customers sense little difference between banks that stem from differences in their charters.

In general, however, dual banking may provide more choices to banks and their customers than may be apparent. Consider the following hypothetical example: Suppose that the regulator of national banks in effect caps agricultural loans at 10 percent of assets and caps holdings of fixed-rate mortgage loans at 10 percent of assets at each national

bank. Suppose also that a state bank regulator, instead, caps agricultural loans at 20 percent of assets and fixed-rate mortgage loans at 5 percent of assets at each of its state banks. Such differences in caps might reflect regulators' recognition of the differences in the credit and interest rate risks of agricultural and fixed-rate mortgage loans and differences in their relative expertise in supervising these two types of loans. These two regulatory policies might lead state and national banks to be equally safe and sound. Nonetheless, the differences in bank regulations allow different banks to focus on, or specialize in, different products. Some customers may prefer to deal with a single bank that focuses on their primary bank product (i.e., their agricultural or mortgage loan). Other customers may prefer to obtain their bank products from several banks, each of which specializes in a different product. Other customers may prefer banks that do not specialize at all. As a result of the regulatory differences that allow banks to specialize more, bank customers have more choice in that they now have access to specialized banks that they would otherwise not have.

The dual banking system also expands choice for banks and their customers who operate across state lines. Differences in regulations across states increase costs for banks that do business across state lines. To the extent that national banks can avoid some of those cross-state-related costs, national banks might have a cost advantage over state banks in providing interstate banking services. As these costs affect the fees and rates that banks charge, customers that need their banks to have cross-state operations are likely to gravitate toward national banks. Customers that do not need such operations are likely to gravitate toward state banks that have other offsetting advantages relative to national banks.

D. Competition Enhances Efficiency

1. Dual banking facilitates uniform national markets

The US dual banking system provides banks with the option of national regulation. For banks that want to operate across state lines, national regulation reduces costs for banks and for their customers, streamlines interstate bank transactions, eases entry by and sharpens competition from out-of-state banks, cushions downturns in local and regional economies, and helps channel funds to areas that offer the greatest benefits to borrowers and the greatest rewards to savers and thereby raises national production and wealth.

Absent national regulation, banks that operate across state lines incur more costs. They incur costs associated with complying with each state's relevant regulations of banks' products and services and all of their attendant contracts and documentation, banks' policies and practices, and any other aspects of banks' businesses. If the differences in relevant regulations across states were relatively minor, banks might adopt products, services, and other aspects of their businesses that were common across states, and comply with disclosure and other regulations by having state-specific contracts, documentation, and so on. If the differences in relevant regulations across states were larger, however, banks that wanted to operate across state lines would have to develop and offer state-specific products, services, and other aspects of their businesses. Either way, the absence of national regulation would raise the costs of serving bank customers across state lines. These higher costs would affect not only large, interstate banks, but also the increasing numbers of smaller banks whose markets cross state lines. Higher

costs for banks (or other financial institutions) that operated across state lines would in turn raise costs paid by customers and reduce their access to financial services.

Estimates of the aggregate amount of these costs are hard to come by. We do, however, have evidence about the costs associated with a few individual activities and banks. The Financial Services Roundtable estimates that the national uniformity of credit reporting standards (as dictated by the Fair Credit Reporting Act (FCRA) of 1970 and the Fair and Accurate Credit Transactions (FACT) Act of 2003) saves the average consumer $195 per year. Many banks recently provided the OCC with estimates of how complying with various state laws increased their costs. Six banks estimated at $44 million the total cost of implementing a California law that mandated a minimum payment warning. Other banks estimated they would need 250 programming days to update computer systems to comply with anti-predatory lending laws in three states plus the District of Columbia. One bank estimated that complying with mandated annual statements for credit card customers would cost $7.1 million.[10]

National regulation also enhances the convenience of interstate bank transactions. Some customers value bank products and services that are uniformly available across state lines. Among them are businesses with customers in more than one state,[11] business travelers, tourists, residents of border towns, people who move to other states, and customers who want products and services that are not otherwise available in their own states.

By making it easier for out-of-state banks to enter local markets, national regulation increases competition. In the absence of national regulation, regulations that vary across states act as “hidden barriers to trade” that restrict entry by out-of-state

competitors and thereby limit competition and correspondingly reduce the benefits to banks and their customers that would flow from competition.[12] Entry by out-of-state banks may also be deterred by uncertainty about whether future state regulations would force interstate banks to truncate national products to fit state-specific regulations.

Because it facilitates interstate banking, national regulation can also help cushion downturns in local economies. The health of local banks tends to mirror the health of their local economies, because their loans and deposits are concentrated in their local markets. As a result, downturns in their local economies tend to reduce the credit available from local banks when it would be most valuable to some creditworthy borrowers. In contrast, the health of an interstate bank is less affected by the health of a local economy, because its loans and deposits tend to be more geographically diversified. Hence, when both local economies and local banks are troubled, interstate banks are less likely to be troubled and more likely to be able to provide credit to local households and businesses when they need it the most.

Interstate banks may also better channel funds from less dynamic, lower-return sectors and regions to more vigorous, higher-return sectors and regions. Better channeling of funds to areas that offer the greatest benefits to borrowers and the greatest rewards to savers raises national production and wealth.

2. Dual banking allows regulations to be tailored to local conditions

State bank regulators may have sufficiently superior local knowledge that they can tailor regulations more effectively to their states' economies while keeping their banks safe and sound. For example, some states' regulators may be more adept at supervising banks with more agricultural loans (and less adept at supervising banks with

other risks). Other states' regulators may be more adept with other categories of loans. As a result, state bank charters might appropriately differ not only from the national charter but also from the charters of other states.

Banks within a state would benefit not only from having a charter that was tailored more effectively to fit local conditions, but also from having a choice of charters. Banks within a state often differ considerably in their business strategies and thus in their mixes of products, services, and customers. As a result, some banks in each state likely find that they can service their customers best through a state charter, while other banks can do so best through a national charter.

3. Dual banking spurs regulatory efficiency and stability

Competition in financial regulation compels regulators to monitor closely which practices and regulations most benefit financial institutions and their customers, to assess whether their operations and regulations are appropriate, and to restrain their operational costs. The dual banking system, then, pressures bank regulators to pass along these efficiencies to banks and, ultimately, to bank customers.

The dual banking system also encourages regulators to be appropriately flexible in their dealings with banks. If a regulator routinely denied requests by banks to launch innovative products and services, introduced ever more costly regulations, or enforced regulations inefficiently, banks and their customers would suffer unduly. Customers would abandon those banks and move to other banks and to nonbank financial institutions. Similarly, banks would abandon those regulators by "flipping" charters. In such cases, the option of banks' flipping charters puts a healthy restraint on regulation.

At the same time that it provides incentives for regulatory innovation and efficiency, the dual banking system also reduces uncertainty about regulation. Banks value regulatory predictability and are more likely to flip away from charters that impose unduly volatile regulations. Regulators are conscious of banks' concerns about regulatory predictability and consequently weigh carefully changes in regulations.

A concern with regulatory competition involves the possibility of "competition in laxity" among regulators – that regulators may sacrifice safety and soundness to attract banks to their respective charters. The Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 was designed to reduce the possibility that regulators would be lax. FDICIA provided for more involvement by the federal government in the regulation and supervision of all federally insured banks, both state and national. For example, the Act imposes "prompt corrective action" on all bank regulators. As a result of this and other provisions of the Act, many analysts regard FDICIA as having reduced the possibility of competition in laxity.

E. Preemption Is Critical for Regulatory Competition

To reap the benefits of competition, it is critical that bank regulators be able to differentiate their charters; that is, regulations that apply to national banks cannot routinely apply to state banks, and vice versa. Without federal preemption of state regulations that conflict with national (banking) regulations, national banks would operate under the same regulations that state banks operate under in each state. Therefore, removing preemption would, in effect, eliminate the dual nature of banking and hamper interstate banking.

State bank regulators may fear that preemption of state laws will place state banks at a competitive disadvantage and ultimately lead to centralized banking regulation. They argue that if national banks are not subject to the same regulations that states impose on state banks, then state banks will switch to national charters. They further argue that state bank regulators then would not be able to resist mimicking national regulations, thereby effectively centralizing bank regulation.

Preemption of state laws, however, need not place state banks, on balance, at a competitive disadvantage. Preemption does mean that some state laws may not apply to national banks. However, these laws may either impose additional costs on banks or grant them additional benefits. That some specific costs or benefits associated with national banks are more favorable to either state banks or national banks does not mean that, on balance, either charter is at a competitive disadvantage. Rather than considering some costs or benefits of a charter in isolation, meaningfully comparing charters requires taking into account the balance of all of a charter's costs and benefits.

Of course, different banks will value the costs and benefits of the state and national bank charters differently, depending on the banks' business strategies and environments, their products and services, and their customers. Thus, some banks will prefer state charters and other banks will prefer national charters. If the market share of either type of charter drops appreciably, then regulators should consider whether their charter has responded effectively enough to its competition.

F. Competition in Financial Regulation in Europe

Competition in financial regulation has spread beyond US banking. For instance, the EU has implemented its own version of a dual banking system. EU legislation

specifies a list of permissible activities for banks, including deposit-taking, lending, investment banking, portfolio management, derivatives trading, and several other activities. Each EU country may permit, regulate, restrict, or forbid these and other activities for banks headquartered within its borders. However, a country may neither (1) restrict within its borders the establishment of branches of banks headquartered in other EU countries, nor (2) prevent those branches from carrying out activities permitted in their home country, if the activities are included in the EU's list of permissible bank activities. Thus, Italy may restrict Italian commercial banks from engaging in investment banking, but may not prevent branches in Italy of a Spanish commercial bank from engaging in investment banking, if investment banking is permitted in Spain.

In addition, under the principle of home country control, a bank's branches outside of its home country are supervised by the bank's home country regulator rather than by that of the host country. In that regard, home country control is a version of dual banking: branches of Spanish and Italian banks that operate side by side (e.g., in Spain, in Italy, or in any other EU country such as Poland) are subject to somewhat different regulations (i.e., those of each home country).

In the EU, these principles apply not only to banks, but also to other parts of the financial sector, such as the insurance and securities industries. The performances of banking and other financial industries in the EU are likely to provide valuable information and insights into the benefits of extending competition in financial regulation to nonbank financial industries in the US, such as finance companies and insurance.

G. Aspects, Old and New, of the Benefits of Competition in Financial Regulation

A number of the benefits that are attributable to competition in financial regulation have been recognized for some time. For convenience, several are recapitulated here. Yet, despite the long history of dual banking in the US, a surprising number have not been recognized widely, if at all, before.

For decades, that competing regulators are more likely to innovate has been testified to by argument and example. While that point has tended to be advanced by academics, bankers seem to have been more likely to stress that having a choice of charters stifles any tendency for regulations to be excessive: The implicit threat of charter flips corrals any regulatory overzealousness. Occasionally acknowledged is that excessive regulation might lead banks or their customers to shift assets out of banks altogether by using nonbank financial institutions.

Some of the novel aspects of competition in financial regulation arise from the introduction over the past decade of reduced restrictions on interstate branching and banking in the US. One of the intriguing, newer aspects of regulatory competition might be termed the "epidemic" feature introduced by the national charter, whereby a state-level regulatory innovation spreads to states near and far via the "carrier" of the nationwide purview of the national charter. This transmission mechanism has received little previous notice. Nor recognized has been the risk mitigating feature of the ballast provided by the banks of one charter, which are not currently covered by a regulatory innovation in the other charter. Similarly, when regulators compete, banks may perceive not only less regulatory overzealousness on average, but also less risk of that zeal. Banks, more than academics, apparently regard this reduced second moment of regulation as being of great moment. Finally, little notice has been given to the ability of a larger

regulator to undertake innovations that have large fixed costs of research, as opposed to the costs of implementation and maintenance.

V. Looking Back and Ahead, or Is Dual Banking "Too Good To Be Two"?

Financial institutions have seized upon the greater opportunities of the past three decades to integrate across banking activities and across nonbanking activities. Much of the deregulation that permitted more integration also stimulated more competition within banking, across banking and nonbanking financial institutions—and even across historically-nonfinancial institutions, and across banks from different countries.

Financial regulation responded. Financial regulation has become more integrated, very largely due to the integration of their regulatees and separately due to the forces that led to the increasing integration of financial institutions. Financial regulation has become more integrated both across banking and nonbanking financial activities and across countries. In the US, the Federal Reserve System is now the regulator of bank holding companies that do more kinds of banking activities and of financial holding companies that do more kinds of nonbanking financial activities than heretofore. In the UK, the FSA has come to be the regulator of UK financial institutions generally.

These developments have led to greater competition, not only between financial institutions, but also between financial regulators. Financial liberalization that allows more of the industries in the US financial sector to compete with each other means that the regulations of those industries are now more in competition with each other. That holds true both for banking and nonbanking financial institutions and regulations. In the US, the Riegle-Neal Act, which dismantled most of the remaining restrictions on interstate banking and branching, was amended in 1997 to permit out-of-state, state banks

to operate their branches under home run regulation. In the same spirit, the EU has specified activities that banks can undertake abroad under home run regulation.

In a contrasting trend, in order to better internalize various externalities, Basel agreements intend to harness the competition between national regulators, and thus of their banks, into agreed-upon channels. In its effective reach across national borders, the Basel Accord and its updated version seek to require uniform standards for the safety and soundness of financial institutions around the world. To the extent that some nations remain outside the Basel agreements, there is scope even for competition between financial institutions whose regulations do and those that do not comport with the Basel agreements. In the case of the US, which intends to adopt a bifurcated arrangement that subjects its largest banks to Basel II and subjects the remaining US banks to Basel I, scope is introduced for an additional dimension of competition between banks subject to different versions of the Basel agreements.

Competition in financial regulation can produce a number of benefits, some of which are well known and some of which apparently have not previously been noted. The prime example of such competition has long been the US dual banking system, which has long allowed US banks to choose between two charters. As yet, relatively few financial institutions have availed themselves of the home run regulation that was ushered in by the 1997 amendments to the Riegle-Neal Act in US and the implementation of home country control in the EU. Regardless of the motives for each of these regulatory shifts, their effect eventually may be the end of the dual banking system. If so, the demise of the dual banking system will likely not be due to the failings of the dual system. Nor is it likely to mean the end of competition in financial regulation.

On the contrary. If, for these reasons the dual banking system were to cease to exist as we now know it, its demise is likely more because it was “too good to be two.” That is, home run regulation opens up the possibility that banking in each US state could be conducted, under one of not just two alternative charters, but rather under any one of 52 charters. (Hypothetically, banks from each of the 50 states plus the District of Columbia plus national banks could be in operation within a single state, each operating under its home run regulations. Similarly, in the EU, banks in a given member state could be operating under any one of one, or soon to be two, dozen different sets of home run regulations.) Thus, the path for the foreseeable future, if not forever, seems likely to lead toward rather more diversity in charter choice and more competition in financial regulation.

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[1] See Cobas, Mote, and Wilcox (2003) for comparisons of the forecasted and actual speeds and extent of advances in financial products and services.

[2] See Barth, Brumbaugh, and Wilcox (2000).

[3] See Donahue (1997) and Inman and Rubinfeld (1997).

[4] For convenience, we use the term "regulation" broadly. Here, regulation refers to regulations, legislation, rules, supervision, or any other governmental authority.

[5] In addition, in the US, federal laws, as opposed to the rules that specifically are applied by their regulator (the OCC in the US) to national banks, generally apply equally in practice, both to local (i.e., state-chartered) and to national banks.

[6] The national charter remains intact.

[7] For the purposes of EU banking legislation, the home country is the country where a bank's headquarters are located and the host country is the foreign country where the branches are located. For instance, regarding branches located in Britain of a bank headquartered in Spain, Spain is the home country and Britain is the host country.

[8] For simplicity, here we do not distinguish among laws, regulations, and supervision.

[9] The process by which bank charters mimic one another can at times be almost automatic. State "wild card" or parity laws aim to grant state banks whatever powers are available to national banks within that state. However, these laws do not prevent states from (1) granting state banks additional powers not available to national banks or (2) introducing additional regulations that are binding on state banks and thus not "covered" by parity laws. Also, federal law may explicitly make some state laws binding for national banks within each state (e.g., branching under the Glass-Steagall Act).

[10] Several recent studies and surveys highlight how variations in state regulations increase costs for insurance companies that operate in multiple states. In particular, survey respondents report that delays in the approval of new products across 50 states led to significant costs and forgone revenues.

[11] These include businesses both large and small, businesses operating in many states or simply across one state border, and businesses that have physical operations in multiple states or that simply deliver goods and services from a single location.

[12] International trade analysis highlights how differences in regulations across jurisdictions act as hidden barriers to trade. These hidden barriers may be more important barriers than transportation costs. For instance, ten years after NAFTA was introduced, Canadian provinces traded more with other Canadian provinces (with which they share the Canadian regulatory framework) than they traded with US states that were sometimes thousands of miles closer.