European Parliament

DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A
ECONOMIC AND SCIENTIFIC POLICY

**Economic and Monetary Affairs**

Employment and Social Affairs

Environment, Public Health and Food Safety

Industry, Research and Energy

Internal Market and Consumer Protection

# Overview and Structure of Financial Supervision and Regulation in the US

**Study for the ECON Committee**

Overview and Structure of Financial Supervision and Regulation in the US

EN

2015

DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

# Overview and Structure of Financial Supervision and Regulation in the US

STUDY

**Abstract**

The study distinguishes '*regulation*' and '*supervision*' in the US and provides a concise overview of the structure of US financial supervision. The US legal system limits financial supervision to financial institutions/ products that investors cannot comprehend on the basis of published financial reports, namely banks. But US supervision has historically overlooked the parent institutions of supervised firms. Moreover, the different legal set-up limits direct comparison of US supervisory arrangements with EU objectives.

The study, managed by Policy Department A, on request of the Committee on Economic and Monetary Affairs (ECON) aims at facilitating ECON's understanding of the complex US system of financial supervision.

IP/A/ECON/2012-16 September 2015
PE 492.470 EN

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.


## AUTHOR

Joseph R. MASON, Professor Louisiana University

## RESPONSIBLE ADMINISTRATORS

Stephanie HONNEFELDER
Doris KOLASSA
Policy Department Economic and Scientific Policy
European Parliament
B-1047 Brussels
E-mail: Poldep-Economy-Science@ep.europa.eu

## EDITING ASSISTANT

Mirari URIARTE, Karine GAUFILLET



## LINGUISTIC VERSIONS

Original: EN

## ABOUT THE EDITOR

Policy departments provide in-house and external expertise to support EP committees and other parliamentary bodies in shaping legislation and exercising democratic scrutiny over EU internal policies.

To contact the Policy Department or to subscribe to its newsletter please write to:
Poldep-Economy-Science@ep.europa.eu

Manuscript completed in July 2015




This document is available on the Internet at:
http://www.europarl.europa.eu/studies

# CONTENT

# LIST OF ABBREVIATIONS

| | |
|---|---|
| **ACSSS** | American Council of State Savings Supervisors |
| **BHC** | Bank Holding Company |
| **BHCPR** | Bank Holding Company Performance Report |
| **CAMELS** | Capital-asset-management-earnings-liquidity-sensitivity to market risk |
| **CFPB** | Consumer Financial Protection Bureau |
| **CFR** | Code of Federal Regulations |
| **CFTC** | Commodity Futures Trading Commission |
| **CSBS** | Conference of State Bank Supervisors |
| **DFA** | Dodd Frank Act |
| **ERISA** | Employee Retirement Income Security Act |
| **FDIC** | Federal Deposit Insurance Corporation |
| **FFIEC** | Federal Financial Institutions Examination Council |
| **FGIC** | Financial Guarantee Insurance Corporation |
| **FHC** | Financial Holding Company |
| **FINRA** | Financial Industry Regulatory Authority, Inc. |
| **FSLIC** | Federal Savings and Loan Insurance Corporation |
| **FRS** | Federal Reserve System |
| **FSLIC** | Federal Savings and Loan Insurance Corporation |
| **FSOC** | Financial Stability Oversight Council |
| **GIC** | Guaranteed Investment Contract |
| **IG** | Inspector General |
| **IRLA** | Insurers Rehabilitation and Liquidation Model Act |
| **JAC** | Joint Audit Committee |
| **MIS** | Management Information System |
| **MMF** | Money Market Fund |
| **MSRB** | Municipal Securities Rulemaking Board |
| **NAIC** | National Association of Insurance Commissioners |
| **NASCUS** | National Association of State Credit Union Supervisors |
| **NCUA** | National Credit Union Association |
| **NIC** | National Information Center |
| **NRSRO** | Nationally Recognized Statistical Rating Organization |
| **NSMIA** | National Securities Markets Improvement Act (1996) |
| **NYSE** | New York Stock Exchange |
| **OCC** | Office of the Comptroller of the Currency |
| **OTS** | Office of Thrift Supervision |
| **PBGC** | Pension Benefit Guaranty Corporation |
| **PCA** | Prompt Corrective Action |
| **PRISM** | Performance Report Information and Surveillance Monitoring |

| | |
|---|---|
| **QFC** | Qualified Financial Contract |
| **SEC** | Securities and Exchange Commission |
| **SIPC** | Securities Investor Protection Corporation |
| **SIV** | Structured Investment Vehicle |
| **SLIC** | State Liaison Committee |
| **SPDA** | Single Premium Deferred Annuity |
| **SRO** | Self Regulatory Organization |
| **SR-SABR** | Supervision and Regulation Statistical Assessment of Bank Risk model |
| **UILA** | Uniform Insurers Liquidation Act |
| **URL** | Uniform Receivership Law |
| **USC** | United States Code |

# LIST OF FIGURES



# LIST OF TABLES



# LIST OF BOXES

# EXECUTIVE SUMMARY AND INTRODUCTION

The present note gives a concise yet comprehensive overview of the structure of US financial supervision of all relevant financial sectors in the US. The note first provides a distinction between **supervision** and **regulation** as applied in practice by US authorities. Then, the note provides an introduction to supervisory details relating to the depository institution (commercial banks, thrifts, and credit unions), insurance, and capital markets segments of the US financial system.

The note offers three main conclusions:

- First, the US legal system allows financial supervision to be limited typically to financial institutions/products that (individual and institutional) investors cannot comprehend on the basis of published financial reports produced according to commonly accepted accounting standards, e.g. annual reports or listing prospectuses. These institutions are referred to economically as ‘informationally opaque’.
- Second, because of historical background it has been socially popular in the US to direct greater financial supervision to depository institutions (commercial banks, thrifts, and credit unions) than other financial institutions like securities markets and investment funds. N.B. the majority of depository institutions are not listed on a stock exchange and thus 'informationally opaque'.
- Last, US depository institution supervision has historically been targeted to certain types of *legal* entities – banks, thrifts, and credit unions as defined by the law – rather than the parent companies of those entities, which were only formally recognized in 1956. Moreover the strict adherence to a *Bank* or *Financial Holding Company* (FHC or BHC) form of organization for those parent companies further limits direct comparison of US arrangements with EU objectives.

While most US financial institutions face some type of regulation, **only US financial institutions operating with ‘high asymmetric information’ face supervision**. The second Chapter reviews how their characteristics of inside supervision, administrative enforcement, and (deposit) insurance guarantees are implemented with regard to US depository institutions (inclusive of banks, thrifts and credit unions), insurance companies (inclusive of life, property and casualty, and financial guarantees) and securities firms (investment banks, securities and commodities (trading) firms, investment funds and exchanges, including broker-dealers, investment advisors, as well as rating agencies).

The main conclusions in regard to these entities are:

- Since depository institutions are the most informationally opaque, they face the classic mix of supervision, regulatory enforcement, and deposit insurance guarantees.
- Insurance companies face supervision and regulatory enforcement, but offer limited insurance guarantees.
- Securities firms face little supervision and offer limited guarantees typically covering fraud and malfeasance (but not market loss).

However, due to historical development of the legal framework, lawmaking, regulation and supervision in the US is a complex net of Federal and state based entities with various powers and capacities operating within different legal levels, from passing laws to formulating rules.

Finally, if this sounds complicated, this is because it is complicated.

# 1. THE DIFFERENCE BETWEEN LEGISLATION, REGULATION AND SUPERVISION IN THE US

The present section compares and contrasts supervision and regulation - based on legislation - in detail and offers an introduction to US institutional distinctions.[1] The purpose of this part is to describe the nature and function of financial supervision in the US. It is important to begin by acknowledging that there is **no strict legal separation between supervision and regulation in the US**. Rather, the distinction is based upon common understanding and usage.

In such usage,

- **regulation** is the practice of ensuring that institutions comply with existing laws and the regulatory interpretations of those laws that comprise regulatory rules.

In contrast,

- **supervision** is the 'on-site examination' and 'off-site monitoring' of regulated institutions.

The first postulate of economic contract theory is that '*there is no such thing as a complete contract.*' **In the regulatory world, rules therefore cannot cover every possible way that regulated institutions can pose risks to the public**. Supervision, therefore, extends beyond merely checking to see if rules are strictly followed (off-site monitoring to ensure a required form is filed or financial ratio maintained), to whether conformity with rules meets merely the intent - rather than the letter – of a regulation and, further, to areas were no rules are yet (or able to be) written.[2] Thus, the distinction between supervision and regulation in the US is based upon common economic understanding of information problems in financial institutions in conjunction with the US legal system, generally, US customs and social norms, and the historical legacy of US banking history. For instance, because of the US legal system, financial supervision is limited to financial institutions and products that (individual and institutional) investors cannot understand and assess on the basis of published financial reports produced according to commonly accepted accounting standards – institutions referred to economically as 'informationally opaque.' That means where standard reporting or prospectuses are sufficient for understanding an investment, legal mechanisms like private lawsuits, class action litigation ('collective redress' in the EU), and lawsuits filed by the US Department of Justice and/or State Attorneys General can be relied upon to incentivize compliance and punish infractions.

---

1 For a more basic introduction to US financial regulators and their responsibilities, the Congressional Research Service paper, *Who Regulates Whom and How? An Overview of US Financial Regulatory Policy for Banking and Securities Markets*, by Edward V. Murphy will be a worthwhile resource.

2 A practical example: Supervision is the foundation of Basel Pillar II. In contrast to Pillar I (capital requirements) and Pillar III (measurements of market value), Pillar II supervision is meant to address risks that are not covered adequately otherwise. If there are sources of bank risk that are not taken into account by the risk weighting process involved in establishing minimum capital ratios under Pillar I, Pillar II supervisory review would be expected to take those into account by imposing a higher capital ratio on the bank than that computed under Pillar I. For instance, the US Office of the Comptroller of the Currency, OCC Bulletin 2008-20: Final Guidance on Supervisory Review Process, 31 July 2008; http://www.occ.gov/news-issuances/bulletins/2008/bulletin-2008-20.html explains that the primary purposes of the Pillar II supervisory reviews include:

- *'Addressing the limitations of minimum risk-based capital requirements as a measure of a bank's full risk profile – including risks not covered or not adequately addressed or quantified in the Pillar 1 capital charges;*
- *Ensuring that each bank is able to assess its own capital adequacy (beyond minimum risk-based capital requirements) based on its risk profile and business model; and*
- *Encouraging banks to develop and use better techniques to identify and measure risk.'*

Still, some may find it curious that supervision and regulation are implemented by related (and most times overlapping) entities – that is, **supervisors are usually also regulators (but not the other way around)**. The main reason for such overlap is because the two activities usually complement one another.[3] One can, therefore, think of supervisory review as providing balance to the regulatory process as regulatory '*rules*' balance supervisory '*discretion*'.

The present section compares and contrasts **supervision and regulation** in more detail and offers an **introduction to US institutional distinctions**.

**Table 1: Key characteristics of US financial supervision and regulation**

| Regulation | Supervision |
|---|---|
| 1. Regulators monitor compliance with existing rules through off-site monitoring of financial disclosure. | 1. Supervision is based upon on-site monitoring and disciplinary actions through auditors. |
| 2. Regulators work out specifics on behalf of Congress outside regular lawmaking process. | 2. Supervision covers less well-defined risks and/or emerging idiosyncratic susceptibilities. |
| 3. Regulatory agencies enforce regulations. | 3. Supervisors can relax strict regulatory compliance when exogenous circumstances are predominant. |
| 4. Regulators are in charge of appeals instead of a separate appellate system. | 4. & 5. Bank protests: Extra-judicial system within a supervisory agency is governed by the Administrative Procedures Act within a supervisory agency. |
| 5. The Inspector General's Office has investigative authority to prevent and prosecute malfeasance or fraud. | |
| 6. Not all regulatory agencies have supervisory powers. | 6. Supervisors have regulatory authority. |
| 7. Laws, rules and regulations are made public. | 7. Supervisors' work is highly confidential. Risk assessments are conveyed in examination reports that are confidential. |

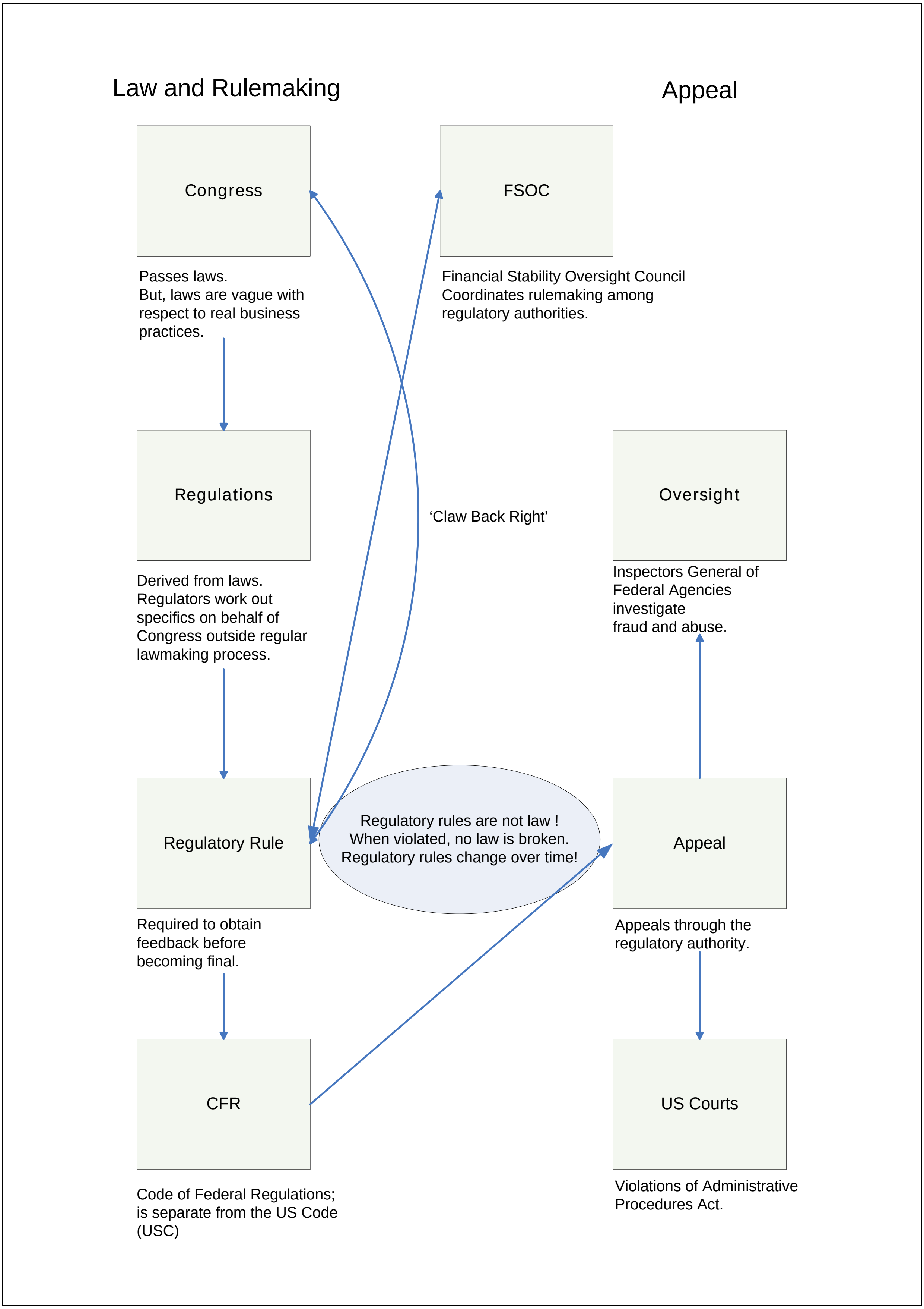
## 1.1. Legislation

To make the distinction more formally and introduce some US institutional concepts, US regulatory rules stem from a process of **legislative lawmaking** and **regulatory rulemaking** that form the codified standards to which financial institutions are held.[4] The process in general is visualized in Figure 1.

[3] Taking the Basel rules as an example: While the Basel guidance on Pillar II acknowledges that some risks are not codified under Pillars I and III, necessitating supervisory review under Pillar II, Basel does not address directly the dynamic interrelationships between Pillar II and the others. Nonetheless, over time, Pillar II supervision should identify areas in which revised risk weights used in Pillar I could codify such risks or market observations in Pillar III could be used to monitor consistently such risks, as idiosyncratic sources of bank risk evolve to become more standardized and commonplace. Such development over time is part of the regulatory rulemaking process, as rules evolve over time to replace discretionary (and sometimes subjective) evaluations of risk.

[4] For a comparative overview see Parker *et al.*

**Figure 1: Law and Rulemaking**



## 1.2. Regulation

### 1.2.1. Legislation Authorizes Regulatory Powers

Legislation initially authorizes regulatory powers over entities in a regulated industry.[5] For instance, in the US, Congress gives bank regulators like the **Office of the Comptroller of the Currency (OCC)** the authority to regulate *Nationally* Chartered Banks, which are those authorized by the OCC to do business, subject to the OCC's authority. In that sense, the OCC is not authorized to regulate *any* company, *just* companies that wish to operate under the statutory definition of a *Nationally* Chartered Bank.

The scope of a bank regulatory authority stems from legislative authorization to oversee the general '*business of banking*' conferred upon regulators in the National Banking Act of 1863 (revised in 1864) and the *incidental powers language* in 12 U.S.C. § 24. The Supreme Court (see for instance Box 1) has recognized that this authority is a broad grant of power to engage in the business of banking regulation and supervision and that the concept evolves over time as business practices develop and change.

### 1.2.2. Legislation Sets the Boundaries of Regulation

Legislation then sets the laws by which regulation is carried out. Those laws define what institutions are regulated and what those regulations entail. But as witnessed in the recent Dodd-Frank Act (DFA) legislation, **laws passed by Congress are often vague with respect to actual business practices, necessitating regulatory interpretation and rulemaking**.

**The regulations that are derived from legislation can, therefore, be very different from those envisioned by Congress.** That is, however, not necessarily a bad thing since the financial system is a highly technical and fast-changing marketplace. It is hard to argue that legislators would, for instance, have sufficient time and expertise to draft Basel Capital rules. Thus, regulators are left to work out the specifics on behalf of Congress outside the regular lawmaking process. **Nonetheless, if regulators stray too far from Congressional intent, Congress can make new laws.** To be noted in this context, Congress may also use appropriations to influence supervisory and regulatory agencies, and the CFTC is supposed to be explicitly reauthorized by Congress every five years to similarly ensure consistency with the law.[6]

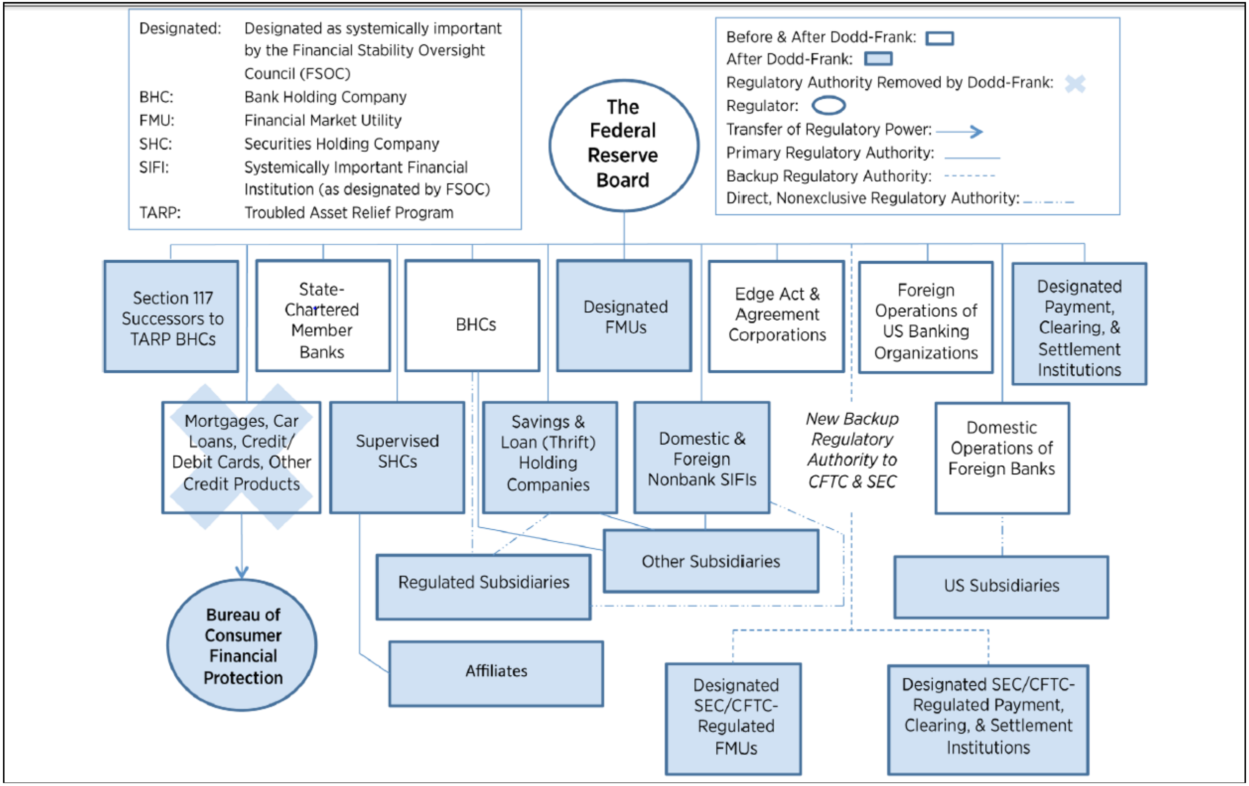
N.B. the European concept is different, based on the understanding that secondary legislation (such as implementing and delegated acts) stay within the boundaries set by primary law which is checked through the procedure of adopting them, and (possibly) the affected industry challenging certain interpretations in court.

---

5 For a general introduction into regulation, see Dudley and Brito.

6 See e.g. CFTC Reauthorization Bill: On 9 April 2014, the House Agriculture Committee approved a bill that would reauthorize the CFTC. That bill is a response to recent events in the futures markets; i.a. the CFTC's interpretation of its required rules under the 2010 Dodd-Frank Act, have raised concerns among end-users of financial futures. Thus the bill aims to address those issues and will roll back some of the agency's new derivatives rules that were implemented under Dodd-Frank. In a summary of the bill, the Committee writes '*Despite Congress' directive to exempt end-users from some of the most costly new regulations associated with using derivatives, the CFTC has narrowly interpreted the law, which has burdened businesses across the country and has threatened the ability of producers to affordably protect against risks associated with farming and ranching.'* The bill includes several reforms to the Commission's internal processes, many of which would weaken the role of the Chairman. The motivation behind these proposals is said to be Republican anger at former Chairman Gensler who they felt operated with too much unfettered authority.

**Figure 2: Dodd-Frank's Impact on the Scope of the Federal Reserve Board's Regulatory Authority**




***Note:*** non-arrow lines between affiliates/subsidiaries and regulated institutions represent Federal Reserve Board regulatory authority through the parent entity over the respective affiliate/subsidy.

***Source:*** Peirce and Greene, The Federal Reserve's Expanding Regulatory Umbrella, April 2013.

### 1.2.3. Regulatory Process of Rulemaking

Nonetheless, regulators are required to obtain feedback on proposed regulations and hold public hearings on their proposed language before regulatory rules become final. The specific requirements for doing so are specified in the Administrative Procedures Act of 1946. **Once finalized, regulatory rules become part of an official compendium that is separate from the US Code (USC), called the 'Code of Federal Regulations' (CFR).**[7]

### 1.2.4. Coordination of the Regulatory Process of Rulemaking

As there are many diverse regulatory authorities (see Chapter 2.), conflicts have sometimes occurred regarding responsibility for rulemaking in different areas of finance. One problem that was thought to have contributed to the mortgage crisis was a significant delay in regulatory rulemaking regarding subprime and high-cost mortgages. Less well-known is the battle between the Federal Reserve and the SEC over bank loan loss reserves in the 1990s.[8]

**Prior to DFA, there existed no formal coordination mechanism of regulatory – rather than supervisory – authorities. Thus, DFA provided for the Financial**

---

[7] For access to the Code of Federal Regulations, see http://www.gpo.gov/fdsys/browse/collectionCfr.action?collectionCode=CFR.

[8] See Balla *et al.*: '*In 1997, the SEC expressed concern that US banks were overstating their loan loss reserves, and in 1998, the commission required SunTrust Bank to restate its earnings for 1994–96, lowering the loan loss reserve by USD 100 million. While directed toward a single bank, the SEC's action reflected a strengthening of accounting priorities— one that might have had an effect on the level of loan loss reserves throughout the banking system.*'

**Stability Oversight Council (FSOC), which is intended to coordinate rulemaking among the multitude of regulatory authorities.**

Still, substantial differences of opinion remain among regulators with regard to such key issues as the implementation of the Volcker rule in the US with the SEC vying against other regulators like the Federal Reserve for the primary authority to determine what constitutes 'proprietary trading'.[9] Thus, the mere existence of the FSOC is contributing little to eradicating the regulatory turf battles that continue to distract US authorities from effective regulatory practices.

### 1.2.5. Interpretation by Regulators of the Laws Passed by Congress

However, subsequent rulemaking applies the law in practice, sometimes interpreting the underlying legislation in a narrower or wider way than perhaps originally intended by Congress. Such adaptations can lead to changes of the law - e.g. either to limit regulators or to acknowledge developments in the legal basis. This is illustrated in Box 1 below:

**Box 1: Regulatory Interpretation**

**Barnett Bank of Marion County N.A. versus Nelson, Florida Insurance Commissioner (1996)**[10]

The McCarran-Ferguson Act of 1916 specifically prohibited banks from selling insurance. Nonetheless, the Act left one exception, where banks, '*if located and doing business in any place with a population […] of not more than five thousand […] may, under such rules and regulations as may be prescribed by the Comptroller of the Currency, act as the agent for any fire, life, or other insurance company authorized by the authorities of the state to do business there, […] by soliciting or selling insurance.*' (Act of Sep 7, 1916 (Federal Statute), 39 Stat. 753, 12 USC. 92). The state of Florida left a similar loophole, stating '*No Florida licensed insurance agent […] who is associated with, […] owned or controlled by […] a financial institution shall engage in insurance agency activities*' (Fla. Stat. Ann. §626.988(2) (Supp. 1996) (State Statute), but defining the term 'financial institution' as '*any bank […] except for a bank which is not a subsidiary or affiliate of a bank holding company and is located in a city having a population of less than 5,000*' §911(1)(a).

In 1993, Barnett Bank of Florida bought an insurance company located in a small town subject to the state statute. While state courts ruled against Barnett's ability to operate the insurance agency (subject, in part, to the definition of a 'place' of population 5,000), there was no dispute in the interpretation of the Florida statute and the Florida and Federal statutes did not contradict one another. Thus, it was ruled that Federal authority of the OCC preempted the State court ruling. Subsequent to appeals to the Supreme Court, the OCC's authority to allow Barnett to sell insurance was affirmed. **Because of a regulatory interpretation, banks could heretofore sell insurance.**

In 1999, Congress passed the Gramm-Leach-Bliley Act, which gave all National Banks authority to sell insurance, legally preempting state laws in this product area.

Regulatory interpretations of the '*business of banking*' can and – by necessity, do – change over time. For instance, during the 1990s regulatory interpretations led to banks offering annuities, insurance, and securities underwriting services that were previously prohibited. In all of those instances, no new legislation was passed – rather, existing laws such as the National Banking Act reinterpreted the 'business of banking' to allow such activities in the modern financial marketplace. Another example: In 2003 the Federal Reserve interpreted physical commodities transactions as sufficiently related to banking to warrant *bank activities*.

Regulatory interpretations may also *exclude* some types of institutions from supervision and/or access to regulatory benefits, i.e. access to special borrowing privileges at the Federal Reserve Banks' Discount Windows or Federal Deposit Insurance. For instance, in June 2013 the Federal Reserve issued a '*push out rule*' declaring that *'a bank that registers as a swap dealer will not be eligible for deposit insurance or access to the Federal Reserve's*

9 See Patterson.

10 Source: Barnett Bank of Marion County, N.A., Petitioner, v. Bill Nelson, Florida Insurance Commissioner, et al.; http://www.law.cornell.edu/supct/html/94-1837.ZO.html.

*discount window unless the bank 'pushes out' its swap activities to non-bank affiliates that are not eligible for deposit insurance or access to the Federal Reserve's discount window, or ceases to engage in such swaps activities altogether.'*[11]

### 1.2.6. Enforcement: Violations and Sanctions

While **regulations are enforced by regulatory agencies**, individuals can in some instances allege violations, particularly with respect to consumer lending provisions.[12]

Since regulatory rules are not laws, when a regulatory rule is violated no law has been broken. Thus, the **violation is weighed in an extra-judicial system of due process**, similar to that established for administrative law in some countries.

Typical remedies for regulatory violations include sanctions against individuals and financial firms. Individual sanctions include monetary fines and barring individuals from employment in banking or financial services. Sanctions against firms include a variety of actions ranging from informal warnings to cease-and-desist orders and institutional restrictions and closures, and ultimately legal actions.

In many cases charged firms prefer to agree settling the charges brought against them by an agency through paying penalties without admitting or denying the allegations.[13]

### 1.2.7. Appeals against Regulatory Authorities' Decisions

If a regulated firm seeks to appeal a decision made by a regulatory authority, that appeal takes place through the same regulatory authority and not though a separate appellate system as in the judicial branch of government.

### 1.2.8. Precautionary Tools: No-action letters and Safe Harbor Provisions

In the event that no regulatory violation is deemed to have occurred or extenuating circumstances exist, an agency may issue a *no-action letter* or construct a *safe harbor provision* regarding the activity.

- **No-action letters** are issued by a regulatory division, in response to a request from a group or individual, and indicate that staff will not recommend enforcement for failure to comply with a rule in specific described circumstances. In a no-action letter, the agency announces that it has been recommended by the divisions within an agency that the agency not take action on certain specific activities for some period of time. A no-action letter does not mean that the activities are permissible, *per se*, but that they will not be challenged by the agency.[14]
- A **safe harbor provision** establishes a set of base criteria by which a legal (not regulatory) violation will be deemed to exist. Safe harbor provisions are a type of

[11] See Davis Polk & Wardwell LLP Client Memorandum, 'Swaps Pushout Rule: Federal Reserve Clarifies Treatment of U.S. Branches of Foreign Banks,' 6 June 2013.

[12] See e.g. http://www.helpwithmybank.gov/complaints/index-file-a-bank-complaint.html.

[13] See e.g. 'Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO; http://www.sec.gov/news/press/2010/2010-123.htm.

[14] See e.g. the CFTC extension of the no-action letter on Staff Advisory Issues 13-69 which states that '*for the avoidance of doubt, Commission action with respect to the issues discussed above may include, without limitation, a rulemaking, an order, or a determination not to take action with respect to such issues, or any intervening legislative developments that render the need for this letter moot*.'; http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-140.pdf. N.B. CFTC Regulation 140.99 defines three types of staff letters that differ in terms of scope and effect: exemptive letters, no-action letters, and interpretative letters.

'self-regulatory' provision that is intended to create incentives for firms to adopt and maintain certain standards in lieu of direct regulatory supervision.[15]

### 1.2.9. Oversight

Oversight of Federal agencies and the due process system is carried out by the Inspector General's Office at each agency.[16] Inspectors general have broad investigative authority to prevent and prosecute malfeasance or fraud in the regulatory process, whether at the stage of establishing rules or enforcing those later on. Still, some matters can filter up to the legal system, particularly where regulatory rules or actions are alleged to have been issued without adequate statutory authority, where regulatory requirements are alleged to require inordinate costs, and where it is alleged that regulatory determinations may be arbitrary and capricious.[17]

### 1.2.10. Regulatory Surveillance and Off-Site Monitoring

Regulators also monitor compliance with existing rules through off-site monitoring of financial disclosures (see Box 2). That function, however, inextricably assumes that the financial disclosures are made accurately and fully for purposes of such monitoring. Supervision ensures that those disclosures are not only accurate and complete, but also ensures that other risks that cannot be so easily summarized do not go overlooked.

**Box 2: Regulatory Surveillance and Off-Site Monitoring**

**The Fed's Monitoring Tools: SR-SABR and BHCPRs[18]**

The Federal Reserve uses automated screening systems to monitor the financial condition and performance of state member banks and BHCs in the period between on-site examinations. Such monitoring and analysis helps '*direct examination resources to institutions that have higher-risk profiles. Screening systems also assist in the planning of examinations by identifying companies that are engaging in new or complex activities.*

*The primary off-site monitoring tool used by the Federal Reserve is the Supervision and Regulation Statistical Assessment of Bank Risk model (SR-SABR). Drawing mainly on the financial data that banks report on their Reports of Condition and Income (Call Reports), SR-SABR uses econometric techniques to identify banks that report financial characteristics weaker than those of other banks assigned similar supervisory ratings. To supplement the SR-SABR screening, the Federal Reserve also monitors various market data, including equity prices, debt spreads, agency ratings, and measures of expected default frequency, to gauge market perceptions of the risk in banking organizations. In addition, the Federal Reserve prepares quarterly Bank Holding Company Performance Reports (BHCPRs) for use in monitoring and inspecting supervised banking organizations. The BHCPRs, which are compiled from data provided by large BHCs in quarterly regulatory reports (FR Y-9C and FR Y-9LP), contain, for individual companies, financial statistics and comparisons with peer companies. BHCPRs are made available to the public on the National Information Center (NIC) website*, see http://www.ffiec.gov.

*Federal Reserve analysts use Performance Report Information and Surveillance Monitoring (PRISM), a querying tool, to access and display financial, surveillance, and examination data. In the analytical module, users can customize the presentation of institutional financial information drawn from Call Reports, Uniform Bank Performance Reports, FR Y-9 statements, BHCPRs, and other regulatory reports. In the surveillance module, users can generate reports summarizing the results of surveillance screening for banks and BHCs.*'

---

[15] For instance, the *US-EU Safe Harbor Agreement on Data Protection* created a voluntary mechanism by which US organizations could demonstrate their compliance with the EU Directive on Data Privacy for purposes of data transfers from the EU by self-certifying that they adhere to certain Privacy Principles (which mirror the core requirements of the EU Directive) and repeating this assertion in their posted privacy policy; http://www.export.gov/safeharbor/eu/eg_main_018365.asp.

[16] See e.g. http://www.treasury.gov/about/organizational-structure/ig/Pages/default.aspx.

[17] See e.g. Vartanian, p. 8.

[18] Source: Quoted from Federal Reserve Board, *Annual Report 2010*, Banking Supervision and Regulation, http://www.federalreserve.gov/publications/annual-report/2010-banking-supervision-regulation.htm.

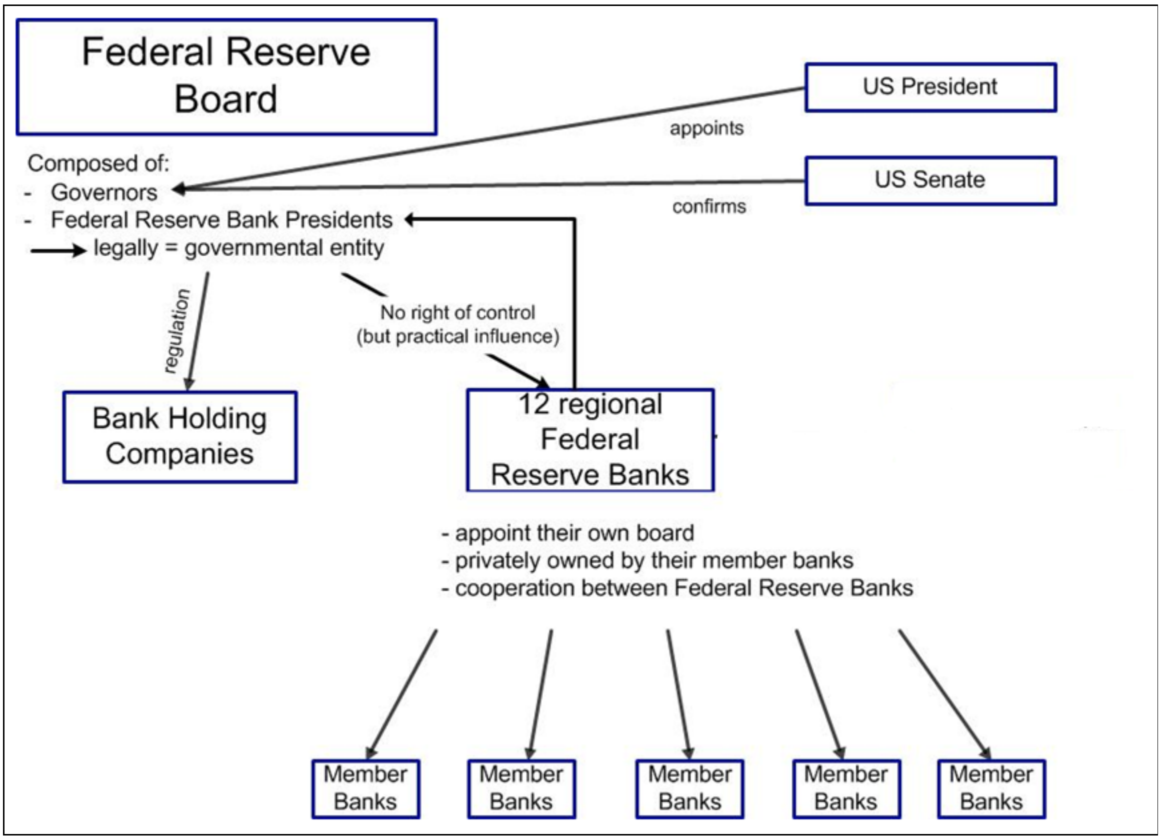
## 1.3. Supervision

The key operational distinction between regulation and supervision is that **regulations are relatively well-defined and codified, whereas supervision covers less well-defined risks and emerging and/or idiosyncratic susceptibilities**. No matter how much regulatory rulemaking occurs, therefore, supervision will always be necessary to address evolving risks as well as risks that are less easily codified in regulatory rules.

It should not be surprising, therefore, that while **all supervisors have regulatory authority, not all regulatory authorities have supervisory powers**. Examples of regulatory authorities with supervisory powers in the US include:

- the Office of the Comptroller of the Currency (OCC),
- the Federal Deposit Insurance Corporation (FDIC), and
- the Federal Reserve Banks (which have authority over banks) and Board (which has authority over bank holding companies, see Figure 3 and Box 3 below).[19]

**Figure 3: The Federal Reserve System**




[19] While the distinction between bank supervisory authority between the Banks and Board has become blurred in recent years, I hew to the common understanding of the division of authority.

**Box 3: The Federal Reserve System**

**The Federal Reserve System**[20]

The Federal Reserve Board is composed of Governors appointed by the President and confirmed by Senate. **The Federal Reserve board has authority to regulate Bank Holding Companies**.

The twelve regional Federal Reserve Banks are nonprofit organizations owned privately by their member bank institutions and independently appoint boards composed of bankers and local business leaders. The Federal Reserve Banks carry out member bank supervision. In recent years, the Federal Reserve Board has become more active in member bank supervision.

Legally, the Board is a governmental entity while the Banks are private entities. Thus, the Board does not control the Banks, but can influence them in important ways.

While there has been cooperation among the Banks and the Board in modern history, the Federal Reserve Banks can choose not to cooperate and set their own policies independently of the Board.

**There exist plenty of regulatory authorities, however, that lack direct supervisory powers**. Authorities, e.g. the Federal Trade Commission (which sets rules regarding consumer credit according to the Equal Credit Opportunity Act and the Fair Credit Reporting Act, among others), lack direct supervisory powers, even while they promulgate important regulations. While the Consumer Financial Protection Bureau (CFPB) has, in theory, been given supervisory powers they have yet to complete an examination.

As introduced above, supervision is based upon on-site monitoring and disciplinary actions. On-site monitoring is carried out by periodic examinations of US financial institutions by specialized teams of **auditors**. The auditors – or 'examiners' – have **broad authority to investigate bank activities and obtain confidential bank documents** and records in order to carry out their work.

Examination processes and procedures are detailed in **supervision manuals** promulgated by the various authorities, like the Federal Reserve[21] and the OCC.[22] Processes and procedures can differ with the type of examination, with specialized examinations dealing with everything from Fair Lending to Bank Secrecy and the Real Estate Settlement Procedures Act. The choice of examination is based upon off-site surveillance and the relevance of the examination type to the bank's business model and current risks.

Since much of their work deals with proprietary bank operations that could expose bank business practices to their competitors or reveal publicly inside information on bank conditions, that **work is kept highly confidential**.

The risk assessments arising from periodic examinations are conveyed in the form of **examination reports** to bank management. Such examination reports and other communications are legally the property of the supervisory authority, such that the entity under supervision does not have the legal right to convey those to the public even if it wanted to do so. In the past, US Courts have routinely denied access to such communications where they could inform lawsuits. Thus, communications between supervisory authorities and financial institutions have long been inaccessible to the public.[23]

Nonetheless, selected Examination Reports were successfully subpoenaed by the Financial Crisis Inquiry Commission and archived at Stanford University as part of their working materials, against the protests of supervisory authorities. **Communications between the supervisor and the bank in the US are strictly confidential**: note in the upper right-

[20] Further reading: Smale, Pauline; Structure and Functions of the Federal Reserve System.

[21] See http://www.federalreserve.gov/boarddocs/supmanual/.

[22] See http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/index-comptrollers-handbook.html.

[23] Public access is granted by the National Archives in cases where the bank in question failed more than thirty years ago and left no successor institution.

hand corner of such materials the designation 'RESTRICED FR,' which means that the release of such documents might cause significant monetary loss, productivity loss, or '*embarrassment to the Federal Reserve System*.'[24]

Such confidentiality has long been viewed as a key element that supports frank evaluation of financial institution risks by supervisory authorities and meaningful discussion of such risks by financial institution personnel. While the importance of such confidentiality remains untested, Courts have remained reluctant to admit supervisory work materials into evidence, maintaining the confidentiality of the communications. Since being made public, the Courts have prohibited even the documents produced by the Financial Crisis Inquiry Commission from being introduced in litigation despite numerous requests to use them as legal evidence in lawsuits related to the mortgage crisis.

While the reports cited begin with a review of the financial condition of the institution, the main focus is on less tangible factors like the risk management systems, the impact of the parent company's condition on the subsidiary banks, and a review of supervisory activities in the prior year and the institution's responses to those findings.

In April 2008, the Federal Reserve announced '*serious deficiencies in Board & Senior Management oversight, policies/procedures/limits, monitoring & Management Information System (MIS), and internal controls*,' at Citigroup during the year of 2007.[25] In 2008, '*the financial condition of the firm deteriorated*' and examiners noted '*serious deficiencies in Board & senior Management relating to the strategic direction of the firm, serious weaknesses in liquidity and risk management, and material weaknesses in the firm's ability and its systems to monitor key vulnerabilities*'.[26]

Such findings – summarized by a composite CAMELS rating of 4 for the firm in 2008, one step away from mandatory closure – would shock a typical bank manager and lead to swift intervention by imposing substantial limitations on bank activities. Similar to the treatment of regulatory rule violations, when supervisors decide that circumstances require remediation, they file a notice of such mandatory actions.

If the bank protests, there again exists the extra-judicial system of due process, governed by the Administrative Procedures Act, within the supervisory agency that is used to hear arguments about the severity and penalties for violations (appeals through the supervisory authorities, not through an appellate system as in the judicial branch of government).

**Supervisory violations are more difficult to enforce than regulatory violations** because there are often no clear rules to point to, only supervisory judgment. Supervisors are, therefore sometimes reluctant to impose sanctions on a firm merely for supervisory violations. Even where violations are regulatory, rather than merely supervisory, in practice banks can forestall sanctions in order to remain in business. Such circumstances led to significant delays closing institutions in the prior US financial crisis in the 1980s. As a result, the Federal Deposit Insurance Corporation Improvement Act of 1991 established what are called '***Prompt Corrective Action***' (PCA) procedures that mandate certain sanctions in the event of violations of certain regulatory thresholds.[27] The PCA thresholds are driven primarily by bank capital levels, as indicated below:

[24] 12 CFR Ch. 11 §268.205, *Access to Sensitive Information.*

[25] *Report of Inspection for Citigroup, Inc., as of December 31, 2007*. Federal Reserve Bank of New York, 15 April 2008, at 1. http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-04-15_FRBNY_Letter_from_John_J_Ruocco_to_Board_of_Directors_of_Citigroup_Re_Annual_report_of_inspection.pdf

[26] *Report of Inspection for Citigroup, Inc., as of December 31, 2008,* Federal Reserve Bank of New York, 14 January 2009; http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2009-01-14%20FRBNY%20Summary%20of%20Supervisory%20Activity%20and%20Findings%20on%20Citi.pdf.

[27] See 12 CFR §6, Prompt Corrective Action, at http://cfr.regstoday.com/12cfr6.aspx.

**Table 2: Prompt Corrective Action Thresholds for US Depository Institutions**

| Capital category | Total risk-based capital[a] | Tier 1 risk-based capital | Leverage capital[b] |
|---|---|---|---|
| Well capitalized[c] | 10% or more and | 6% or more and | 5% or more |
| Adequately capitalized | 8% or more and | 4% or more and | 4% or more[d] |
| Undercapitalized | Less than 8% or | Less than 4% or | Less than 4% |
| Significantly undercapitalized | Less than 6% or | Less than 3% or | Less than 3% |
| Critically undercapitalized | An institution is critically undercapitalized if its tangible equity is equal to or less than 2% of total assets regardless of its other capital ratios.[e] | | |

**Source:** United States Government Accountability Office (GAO) Report GAO-11-612, p. 10.
Capital measures and capital category definitions: FDIC—12 C.F.R. § 325.103, Federal Reserve—12 C.F.R. § 208.43, OCC—12 C.F.R. § 6.4, and OTS—12 C.F.R. § 565.4.
[a]The total risk-based capital ratio consists of the sum of Tier 1 and Tier 2 capital divided by risk-weighted assets. Tier 1 capital consists primarily of tangible equity (see note e). Tier 2 capital includes limited amounts of subordinated debt, loan loss reserves, and certain other instruments.
[b]Leverage capital is Tier 1 capital divided by average total assets.
[c]An institution that satisfies the capital measures for a well-capitalized institution but is subject to a formal enforcement action that requires it to meet and maintain a specific capital level is considered to be adequately capitalized for purposes of PCA.
[d]CAMELS 1-rated institutions not experiencing or anticipating significant growth need have only three percent leverage capital to be considered adequately capitalized.
[e]Tangible equity is equal to the amount of Tier 1 capital elements plus outstanding cumulative perpetual preferred stock minus all intangible assets not previously deducted, except certain purchased mortgage-servicing rights. Cumulative perpetual preferred stock is stock that has no maturity date, cannot be redeemed at the option of the holder, has no other provisions that will require future redemption of the issue, and provides for the accumulation or future payment of unpaid dividends. Intangible assets are those assets that are required to be reported as intangible assets in a bank's Call Report or thrift's Thrift Financial Report.

Under PCA, authorities *must* take increasingly stringent supervisory actions as a bank's capital level deteriorates. For example, all undercapitalized banks must implement capital restoration plans to restore capital to at least the adequately capitalized level, and regulators generally must close critically undercapitalized banks within a 90-day period.

PCA also authorizes some flexibility to the strict interpretation of capital levels. For instance, '*regulators can reclassify or downgrade a bank's capital category to apply more stringent operating restrictions or requirements if they determine, after notice and opportunity for a hearing, that a bank is in an unsafe and unsound condition or engaging in an unsafe or unsound practice*'. Supervisors can typically use discretion to assess bank safety and soundness in terms of: '*(1) operations and management; (2) compensation; and (3) asset quality, earnings, and stock valuation*'.[28]

## 1.4. Regulatory Rules and Supervisory Discretion in Practice

It is important to note that PCA arose from a perceived lack of supervisory action to address risks at US depository institutions in the 1980s. Indeed, inconsistencies in supervisory treatment have spurred many formal regulations including not only PCA, but also those relating to capital ratios (Basel Pillar I). Both stemmed from what was thought to be supervisory forbearance in the US Thrift Crisis of the late 1980s, during which time a number of US financial institutions were *not* closed when they were obviously insolvent.[29]

Despite the risk of subjective application, supervisory judgment should complement objective regulatory rules by pointing out risks that are growing in consistency across

[28] See GAO Report 11-612.

[29] See Federal Deposit Insurance Corporation (1998) and (1997). Indeed, it could be argued that the 'too big to fail' and 'too connected to fail' policies that were born in the Thrift Crisis have been extended more recently, rather than constrained by the regulatory rules that were meant to alleviate perverse incentives of supervisors capitulating to large and politically connected banks.

institutions. Thus, there will **always remain a need for supervision to augment regulation**; e.g. when **new financial products**, that have yet to be standardized enough to apply rules, need to be supervised to ensure that their risks do not overwhelm traditional bank activities.

Moreover, supervisory judgment is also used to address **unique national and local economic conditions** to help maintain a smooth functioning financial system in a more flexible manner than regulatory rules. For instance, supervision always plays a key role in maintaining economic stability through times of **natural disasters**, helping banks maintain operations to deal with credit needs to recover from hurricanes, floods, and fires. In times of natural disasters, banks regularly struggle to meet the strict letter of regulatory rules regarding clearing and settlement times, cash reserves, and capital ratios due to exogenous circumstances that have nothing to do with their internal management or strategy decisions. In such times, supervisors can use discretion to relax regulatory constraints temporarily in order to allow otherwise sound banks to meet the needs of their local communities and economies and promote recovery and growth.[30]

In addition, during **financial crises** supervisors can relax strict regulatory compliance to allow banks that are merely harmed systemically – as opposed to those that are insolvent due to their own operational and management decisions – to similarly meet the needs of their communities and economies and promote recovery and growth. Moreover, in making the distinction between those institutions harmed merely systemically and those that are the source of the difficulties, supervisors can help alleviate pressures arising from asymmetric information and lead investors (including depositors) to return to sound investments in the financial services sector.[31]

Both regulatory rules and supervisory discretion are therefore equally critical to financial institution safety and soundness. Safety and soundness helps stabilize credit flow in the face of asymmetric information shocks (i.e., financial crises), maintaining the primary transmission mechanism of monetary policy and facilitating smooth recoveries from business cycle downturns. Both regulatory rules and supervisory discretion are, therefore, crucial to a well-functioning economic system.

[30] See Yandle on regulatory flexibility.

[31] Note, however that what is described here is not a bailout of the insolvent institutions, but assistance to institutions temporarily afflicted by those insolvent institutions. Thus, the distinction between the two must be based upon credible factual evidence, such as that usually gathered (confidentially) in the supervisory process. If a bailout of insolvent institutions is desired, nonetheless, supervisory information can be used to perform triage at institutional level to decide which institutions can be helped and which must be closed, either immediately or eventually. Thus, supervisory information can reduce the cost of a bailout, if one is desired.

# 2. SUPERVISORY STRUCTURES WITHIN THE US FINANCIAL SYSTEM

While most US financial institutions face some type of regulation, **only US financial institutions operating with 'high asymmetric information' face supervision**. The combination of inside supervision,[32] administrative enforcement,[33] and (deposit) insurance guarantees[34] are the chief characteristics of such institutions.

This chapter reviews how those characteristics are implemented with regard to US depository institutions (inclusive of banks, thrifts and credit unions), insurance companies (inclusive of life, property and casualty, and financial guarantees) and securities firms (investment banks, securities and commodities (trading) firms, investment funds and exchanges, including broker-dealers, investment advisors, as well as rating agencies (NRSROs)).

Since depository institutions are the most informationally opaque, they face the classic mix of supervision, regulatory enforcement, and insurance guarantees. Insurance companies face supervision and regulatory enforcement, but offer limited insurance guarantees. Securities firms face little supervision and offer limited guarantees typically covering fraud and malfeasance (but not market loss).

To be noted that, different from the common set-up in the EU, some agencies in the US have to be periodically be re-authorized (e.g. the CFTC every five years) which usually provides an occasion to also (try to) change their operations and/or tasks.[35]

## 2.1. Depository Institutions

Depository institutions are the most informationally opaque financial institutions in the US economy. Depository institution 'investors' are actually customers who typically maintain relatively small short-term balances, i.e. deposits, in the institution. They are typically less sophisticated than other financial market participants (usually they are not adept at reading financial statements and understanding bank risks) and the depository institution financial transactions made with those funds tend, themselves, to be either small (e.g. deposits, individual mortgages, automobile loans, or credit card loans) or unique (i.e. financial arrangements that meet unique funding needs that markets cannot address[36]).

---

32 Carried out by examiners inside the firm with access to proprietary information rather than investors or other monitors outside the firm with access to market information.

33 Rather than legal recourse offered to outside investors or other monitors of the firm.

34 Rather than legal damages available to outside monitors and investors.

35 The CFTC is supposed to be reauthorized every five years (statutory authorization expires at the end of the fiscal year, i.e. September 2013). But Congress often misses that self-imposed deadline.

The House of Representatives has only recently (June 2014) passed its version of a CFTC Reauthorization Bill (H.R. 4413 Customer Protection and End User Relief Act, https://www.congress.gov/bill/113th-congress/house-bill/4413?q=%7B%22search%22%3A%5B%22hr+4413%22%5D%7D). The bill would reauthorize the CFTC through to September 2018; but does not provide the CFTC with additional funding and makes several significant changes to the way the CFTC operates as a commission and regulates derivatives and swaps under the DFA, see http://agriculture.house.gov/issue/cftc-reauthorization. Congress similarly constrains SEC funding. See for instance, http://www.complianceweek.com/blogs/enforcement-action/house-bill-slashes-300-million-from-pres-obamas-proposed-sec-budget.

The text proposed by the House of Representatives has be considered by the Senate and signed by the President prior to enactment. However, the House and the Senate bills may have substantial differences. The two bills must then be reconciled by Congress before they are presented to the President. If the House and the Senate fail to reach an agreement, Congress may reauthorize the CFTC temporarily for an additional year based on the current statutory authorization.

36 For instance, commercial banks routinely utilize derivatives to construct new financial products for their customers. Often banks hold the other side of those new arrangements and attempt to limit their risks through other offsetting derivatives contracts. As a result, banks are major market participants in the USD 535 trillion interest rate derivatives market. Moreover, while policymakers seek to regulate the USD 24 trillion credit

But depository institutions are thought to be particularly valuable to economic growth and development because they characteristically aggregate small short-term depositor/investor balances into investments that fuel consumption and economic growth. Supervision of depository institutions is therefore typically implemented to bridge the gap across the chasm between depositors and bank investments, maintaining bank 'safety and soundness' on behalf of individual depositors as well as economic growth.

### 2.1.1. General Structure

It is important to realize that everything discussed below relates solely to depository *institutions*, not depository institution *holding companies*. Box 4 describes the historical background to US banking that shows, first, how depository institution supervision was initially designed to apply to individual, small institutions, who then became only small parts of larger holding companies when, under the Bank Holding Company Act of 1956, US banks (and later, thrifts) were allowed to operate in special corporate holding companies legally labeled **Bank Holding Companies** (BHCs).[37] Thus, the depository institutions and the supervisors that oversee them relate solely to the *subsidiaries* in the holding company structure, not the holding company, itself.

**Box 4: US Bank and Bank Holding Company Supervision**

**A Brief History of US Bank and Bank Holding Company Supervision**

Colonial settlers did not care for financial institutions and therefore were reluctant to give commercial banks Federal legal status upon creation of the United States. Each state, therefore, created its own financial regulations and supervisory structure. Before the 1850s, most states restricted banks to a single office, sometimes referred to as a 'unit bank' system. Without branches, bank growth was significantly constrained.

In 1863, a Federal banking charter was introduced. Generally, however, the Federal government cannot compel States to change their laws. Thus, the Federal charter –creating a national bank – could not address the growth constraints imposed by unit banking. The Federal Reserve System was established in 1913, adding another layer of supervision to the structure.

The McFadden Act of 1927 clarified branching restrictions relating to National banks, allowing National banks to open branches in states that allowed such activities. The Federal Deposit Insurance Corporation was established in 1934, adding yet another layer to bank supervision.

The Bank Holding Company Act of 1956 organized the US system around holding companies (regulated by the Federal Reserve Board) rather than universal bank structures related to financial conglomerates. A bank holding company, however, is not a bank. Thus, while the Federal Reserve Board was given authority over the regulation of such entities, the SEC shares (via supervisory authority on reporting and on securities entities in the holding company) authority over them as it relates to financial reporting and trading of stocks in all other non-bank companies in the US.

The Gramm-Leach-Bliley Financial Modernization Act (1999) removed restrictions on business activities of securities underwriting subsidiaries of bank holding companies, further stimulating the SEC to become more active in bank regulation.

DFA similarly does little to simplify the supervisory overlap and, indeed, has caused further consternation between the Federal Reserve and SEC regarding oversight and implementation of the Volcker rule on proprietary trading. Moreover, traditional regulatory authorities still supervise banks, not bank holding companies. Recently, the mixing of banking business and commercial activities, namely in physical commodities, have become an issue of investigations.[38]

derivatives market, it is important to remember that even credit derivative index products comprising roughly half the market were first introduced only in 2005-2007. Mark Pittman (http://www.bloomberg.com/apps/news?sid=aA6YC1xKUoek&pid=newsarchive) provides the narrative of the most dramatic story of such developments to illustrate how such products develop informally and that while one would always wish to be aware of such developments, one would never want to stifle them.

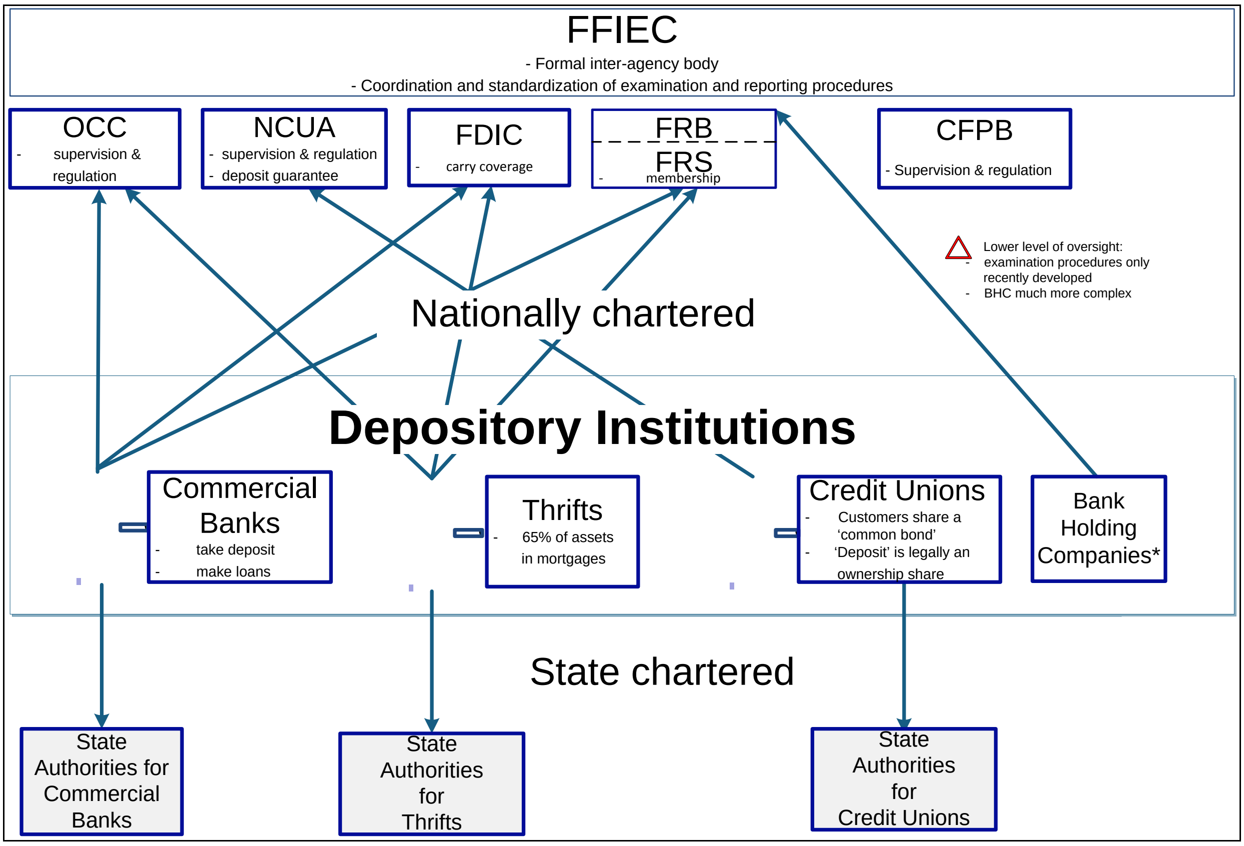
[37] Unlike a regular corporate holding company, a BHC cannot own subsidiaries that engage in unapproved non-bank 'commercial' activities. A BHC, therefore, could not own, say, an automobile manufacturing subsidiary.

[38] The Senate Permanent Subcommittee on Investigations released end 2014 a report investigating leading Wall Street banks' involvement with physical commodities which is a result of investigations launched in 2012. The report contains detailed findings about activities and consequences the engagement of Goldman Sachs,

Depository institutions in the US are principally comprised of three types of legal entities: Commercial Banks, Thrifts, and Credit Unions. The differences in each arise largely from social obligations of the different institutions.

- **Commercial banks** take deposits (legally defined as balances that may be redeemed upon demand) and make loans. Commercial banks deal with the general public and routinely provide loans to businesses as well as individuals.
- **Thrifts** seem outwardly similar to banks, but differ in significant ways, internally. Most importantly, thrifts must pass a qualified thrift lender test, requiring them to have at least 65% of their assets in mortgages.
- **Credit unions** are, again, outwardly similar but again, different internally. They are financial cooperatives, democratically controlled and owned by their members. Their purpose is to promote thrift, provide credit (at competitive rates) and other financial services to their members. Thus, credit union customers must share a 'common bond' in order to transact with a credit union. The 'deposit' a customer places in a credit union represents legally an ownership share, and is technically referred to as a share draft.

**Figure 4: Simplified Overview on Primary Supervision and Regulation of Depository Institutions**



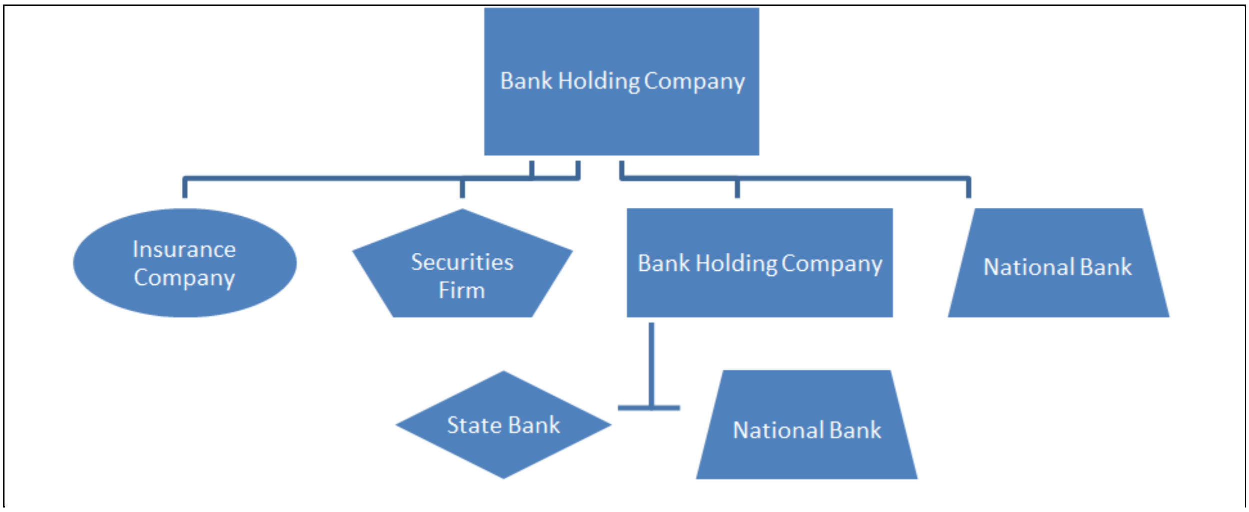

* For Bank Holding Companies, the appropriate term is not 'charter' but 'approval'.
For more detail (in particular on secondary supervision, see figure 12 in the annex).

JP Morgan and Morgan Stanley in the business of physical commodities; http://www.hsgac.senate.gov/download/report-wall-street-involvement-with-physical-commodities.

**Bank Holding Company**

A stylized operational structure of a bank holding company is represented below. It is important to note that **each entity on the second level of the holding company is an individual corporate entity, legally independent of others in the structure**. This may differ from the organization of financial conglomerates in other parts of the world, where the bank, insurance, and securities operations in the figure may be authorized as corporate divisions of the bank, or lying organizationally within the same legal entity that is the financial conglomerate.

**Figure 5: Stylized Bank Holding Company Structure**




Additionally, the figure shows the complexity embedded in the US financial system. In practice, there can be Bank Holding Companies owned by Bank Holding Companies and supervised depository institutions at any level of the hierarchy. An internal study undertaken at the OCC some years ago found up to sixteen layers of Bank Holding Companies within a single Top-tier Bank Holding Company.

### 2.1.2. Supervisory Bodies

In general, US *depository institutions* (of the categories commercial banks, thrifts, and credit unions) choose whether to organize legally under Federal or state rules.

**(i) Commercial banks** are licensed to do business (chartered) by state or Federal authorities at the bank managers' discretion. The *chartering* process – referred to as *licensing* or *authorization* in some countries outside the US – is the procedure for establishing the legal entity that is to be the commercial bank. In the US, a **'commercial bank' is a company that both takes deposits and makes loans. Only commercial banks can undertake those two activities.** While non-banks can make loans and other non-banks can issue demandable debt, a non-bank that strives to do both or any non-authorized company that attempts to use the term 'bank' in its title will run afoul of regulatory authority.[39] In the US, as in most countries, the proposed institution will have to be authorized by the regulatory authority. Most simply, the institution will have to file paperwork naming its principal officers and directors and sources of capital. Those individuals cannot have been previously barred from the business of banking by regulatory authorities and must be otherwise of sound character. **Unlike as in the EU, in the US a charter can be denied for various additional reasons, including competitive**

[39] See, e.g., http://occ.treas.gov/topics/licensing/index-licensing.html.

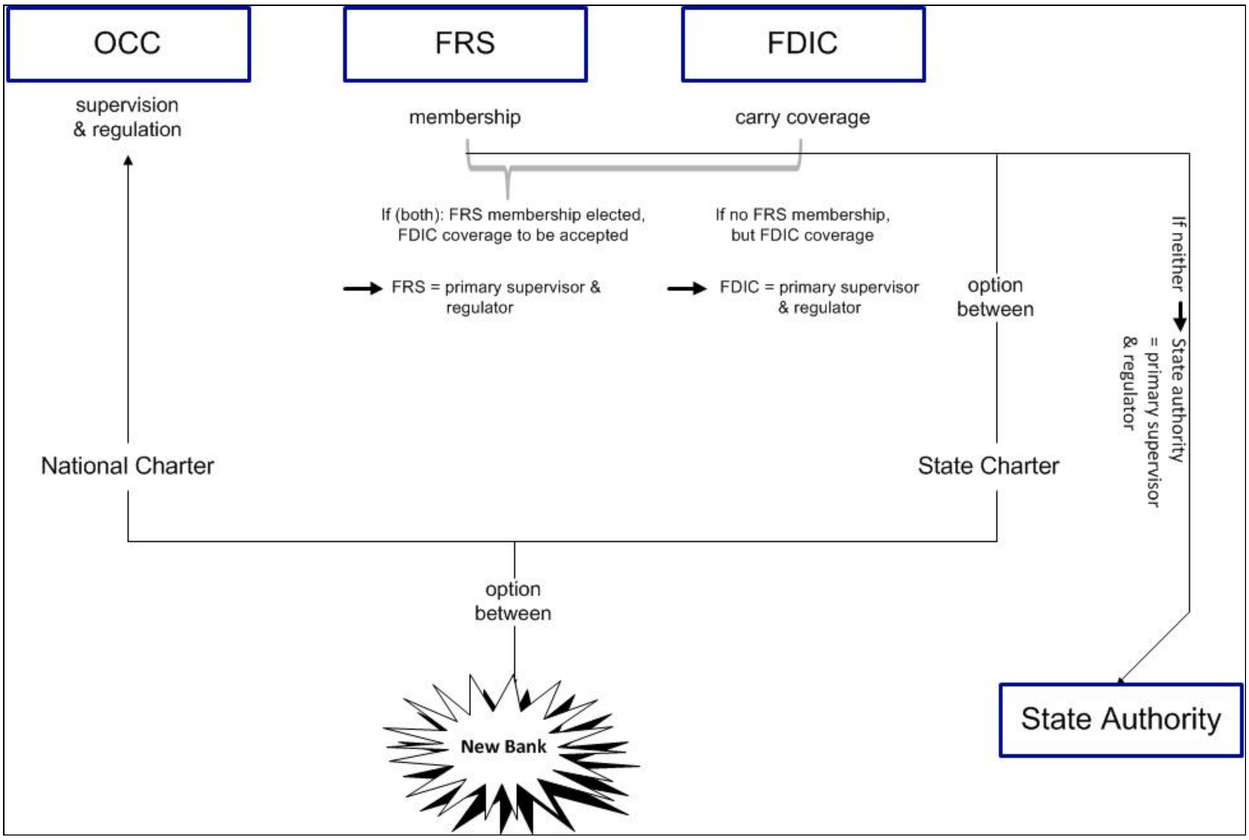
**concerns, i.e., too many banks already in the geographic region or too big a deposit share in the market, and other restrictions.**[40]

**In the US a commercial bank 'in the making' also has a certain discretion to 'choose' its supervisor:** A proposed bank can appeal for a *national* or a *state* 'charter' (i.e. a license or authorization).

- If a bank obtains a **national** charter, it is a National Bank and 'primarily' supervised and regulated by the OCC. Nationally chartered banks are required to become members of the Federal Reserve System (FRS) and carry Federal Deposit Insurance Corporation (FDIC) coverage/guarantees.
- If an institution obtains a **state** charter (becoming a state bank), it is subject to state laws and regulations and *may* be primarily regulated by state authorities, depending upon whether it elects FRS membership and FDIC coverage:
  (a) If it elects FRS membership it must also accept FDIC coverage, and FRS will be the primary supervisor and regulator.
  (b) If it does not have FRS membership and elects FDIC coverage, FDIC will be the primary supervisor and regulator.
  (c) If it has neither, the state authority is the primary supervisor and regulator.

While supervisors other than primary supervisory can investigate bank activities, they must ask for access from the primary authority.

**Figure 6: Commercial Bank Supervision and Regulation**

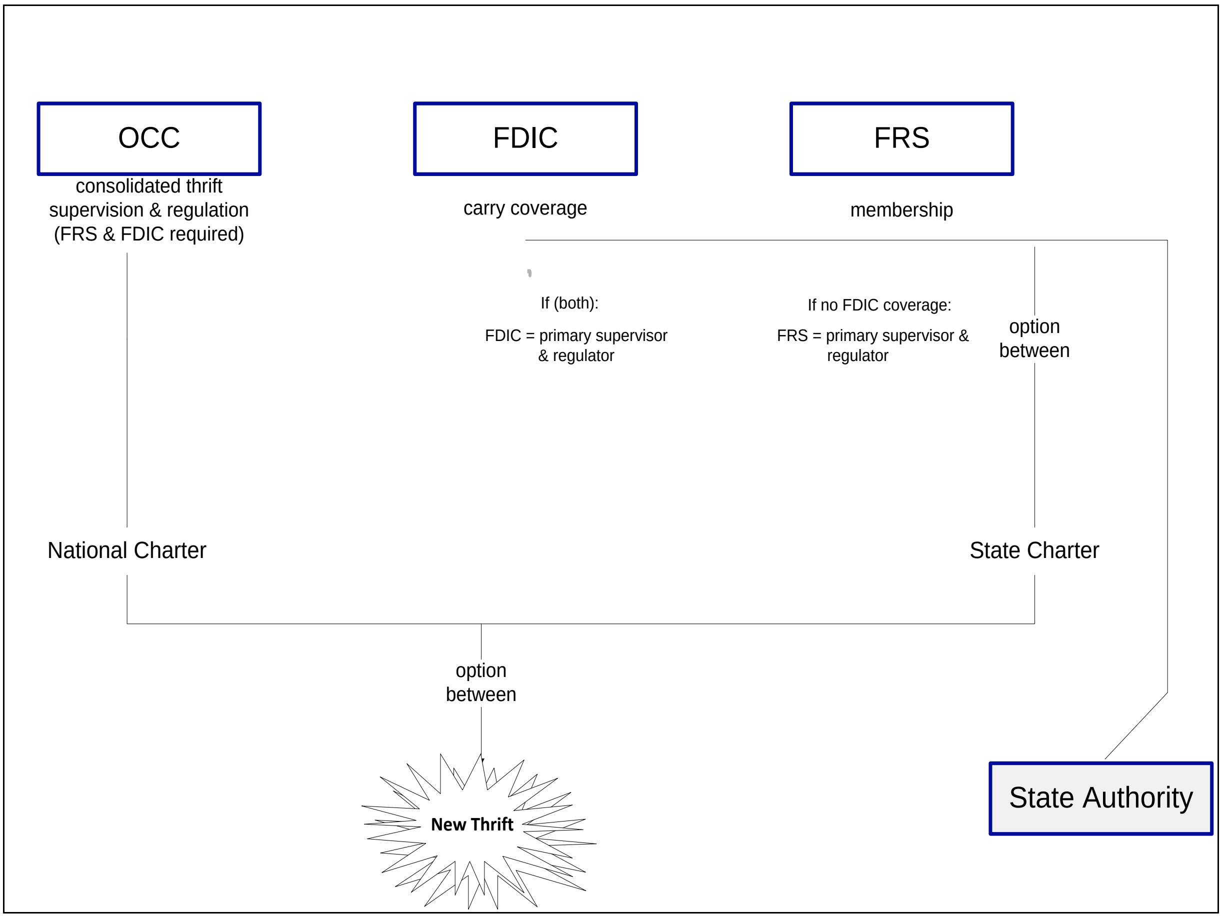



[40] Bank branches undergo a similar authorization process. New branch applications may be denied in response to concerns about fair lending arising from the Community Reinvestment Act and other competitive reasons.

**(ii) Thrifts** may also be licensed by Federal or state authorities. Prior to the mortgage crisis, the primary supervisor of nationally chartered thrifts was the Office of Thrift Supervision (OTS), with the FDIC providing deposit guarantees.

In September 2008, the USD 307 billion asset Washington Mutual – a thrift, not a commercial bank – was sold to JP Morgan for USD 1.9 billion after being seized by regulators. Following the US Thrift Crisis in the 1980s and the failure of Washington Mutual, **DFA** did away with the OTS and **consolidated Federal thrift supervision under the OCC.**[41]

**Figure 7: Thrift Supervision and Regulation after Crisis/DFA**

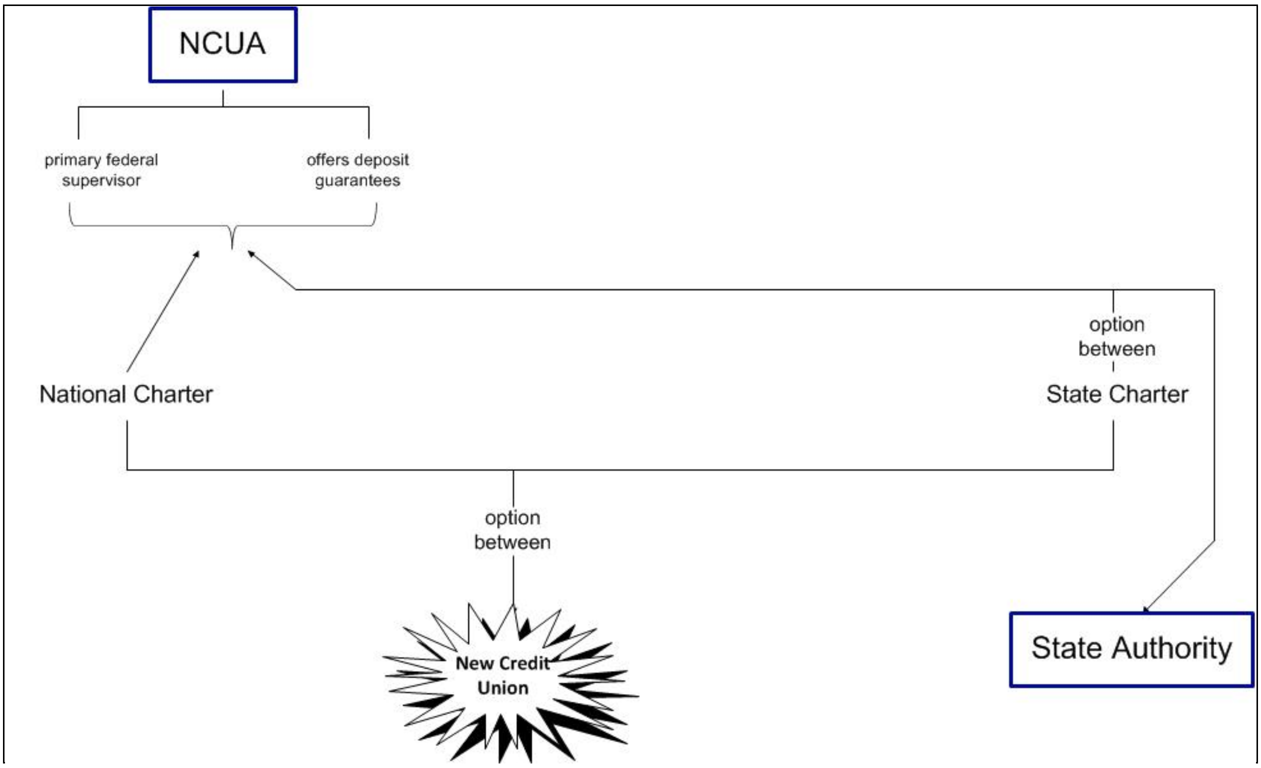



[41] See Dash, Eric, and Sorkin, Andrew Ross. 'Government Seizes WaMu and Sells Some Assets,' *New York Times*, 25 September 2008 at http://www.nytimes.com/2008/09/26/business/26wamu.html?pagewanted=all&_r=0.

**(iii) Credit unions** also have Federal and state chartering authorities and offer deposit guarantees through the **National Credit Union Administration (NCUA)**, which is also the **primary Federal supervisor**, i.e. there are federally insured, state chartered credit unions.

Four corporate credit unions (and also the large U.S. Central Federal Credit Union which provided liquidity loans and other payment services to other credit unions and was holding a total of 75% of credit union industry assets) failed in the recent mortgage crisis.[42] Subject to certain conditions and requirements, credit unions can participate in so called *credit union service organizations* (CUSOs) which provide a specific range of banking-related services to them.[43]

**Figure 8: Credit Union Supervision and Regulation**




[42] See GAO Report on *National Credit Union Administration, and* NCUA press release http://www.ncua.gov/News/Pages/NW20121029USCentral.aspx.

[43] Such permitted services fall into several categories which include checking and currency services, clerical, professional and management services, business loan origination, consumer mortgage origination, electronic transaction services, financial counseling services, fixed asset services, insurance brokerage or agency, leasing, loan support services, record retention, security and disaster recovery services, securities brokerage services, student loan origination, trust agency services, real estate brokerage services, credit card loan origination, and payroll processing services.

**(iv) Bank holding companies** fall under the Federal Reserve Board's regulatory authority according to the Bank Holding Company Act of 1956. While bank holding companies file regular reports (called Y-9's) with the Board for off-site monitoring, there is not the same level of supervisory oversight (i.e. examiners auditing the holding company) at holding companies as there is at banks.

There are two primary reasons for the **lower level of oversight**. First, BHC examination procedures have been developed only recently and, second, BHCs are much more complex, with entities outside the reach of the Federal Reserve's supervisory authority.

Nonetheless, the Federal Reserve Board has, over time, continued to develop more comprehensive examination procedures and sought to broaden the oversight of BHC subsidiaries in a way that can address the whole group of entities, inclusive of the non-bank entities. In 2005, the Board introduced composite ratings for holding companies, much like those it produces for banks.[44]

Of course, the Federal Reserve has no statutory authority over securities firms and insurance companies, so the best it has been able to do in recent years is monitor those entities and their relationship with the parent company and the depository institutions with which it does have formal authority. Most recently, the Board has taken some steps under rulemaking pursuant to DFA to attempt to consolidate supervision further, beginning with securities affiliates of foreign holding companies. While that could clash with SEC authority over such entities, it could potentially unify authority in a way that would clarify holding company conditions.[45]

If this sounds complex, that is because it is complex. To facilitate communication and to avoid overlap, the **Federal Financial Institutions Examination Council (FFIEC)**, established in 1979, exists to coordinate the multiple agencies and standardize examination procedures and reporting. **FFIEC is a formal interagency body that deals specifically with the *federal* examination of financial institutions by the Federal Reserve Board, FDIC, NCUA, OCC, and the CFPB and to make recommendations to promote uniformity in the supervision of financial institutions.**

'*The Council is responsible for developing uniform reporting systems for federally supervised financial institutions, their holding companies, and the nonfinancial institution subsidiaries of those institutions and holding companies. It conducts schools for examiners employed by the five federal member agencies represented on the Council and makes those schools available to employees of state agencies that supervise financial institutions.*'[46]

The FFIEC also maintains an advisory State Liaison Committee composed of five representatives of state supervisory agencies, one of which has voting power within the FFIEC.[47]

### 2.1.3. Funding

Different supervisory functions are funded in different ways. For instance, while insured depository institutions pay to support a deposit insurance fund at the FDIC, once the fund meets its target level no more assessments (i.e. contributions) are required. In contrast, OCC and Federal Reserve supervision is funded by assessments upon the banks supervised.

44 See, for instance, http://www.stlouisfed.org/publications/cb/articles/?id=835.

45 See e.g. 'Federal Reserve Board reaches over SEC for US broker-dealers of foreign banking organizations,' 23 January 2013, http://www.lexology.com/library/detail.aspx?g=a590e8f1-bc66-4cd7-98f8-558b4fcad64a. Nonetheless, such clashes are not new. The Federal Reserve has long fought with the SEC over bank loan loss reserving following a famous 1997 incident in which the SEC required SunTrust Bank to restate its earnings for 1994–96, lowering the loan loss reserve by USD 100 million against the wishes of the Federal Reserve and other regulatory authorities, see Balla et al.

46 See http://www.ffiec.gov/about.htm.

47 See http://www.ffiec.gov/about.htm.

The costs of supervision by different authorities have varied over time. While there is no hard evidence on supervisory efficiency, there has long existed a contested academic and policy debate regarding whether supervisors compete for 'laxity' in order to attract institutions to their charge or whether the national bank charter (license) – which subjects the bank to OCC authority – is so superior to others in terms of power as well as supervisory efficiency that there exists no such competition.

The truth of the matter is probably somewhere in the middle. Most large banks maintain supervisory authority with the OCC. Still, since state authorities sometimes allow activities that Federal authorities (OCC) do not, it can be worthwhile to also maintain a few select state-chartered banks (as well as a Cayman Island subsidiary) within the larger holding company in order to undertake those activities prohibited by the Federal authorities.

### 2.1.4. Deposit Insurance Structure

Depository institution 'investors' (depositors in banks and thrifts) are routinely provided with deposit insurance to help assure them that their balances are safe so that they do not suddenly withdraw funds from financial markets. Currently, depositors are insured by the FDIC and NCUA for '*at least USD 250,000 per bank*'. That language is important, for US deposit insurance used to be limited to '*up to*' rather than '*at least*'. The reason for the change is that, *de facto*, depositor balances exceeding the coverage limits have been covered by the deposit insurance, leading the authorities to drop the appearance of the limitation.

While the US provides deposit *insurance*, the EU concept is that of a deposit *guarantee* (which is not the same, although it might result in a similar outcome if triggered). In contrast to EU provisions, the FDIC operates a national depositor preference regime[48] and its definition of deposit is such that deposits at foreign branches of US banks are not insured by the FDIC[49] (however, branches on military bases are).

### 2.1.5. Resolution Process

If supervisors do their job and close depository institutions before they are economically insolvent, by definition the institution will have sufficient funds upon (eventual) liquidation to reimburse the deposit insurer for any funds it pays out in bank resolutions.

**As a result, non-FDIC supervisors** of FDIC-insured banks (i.e., the OCC and the Federal Reserve Banks) **can sometimes take a more sanguine view of economic and depository institution difficulties than FDIC supervisors.** That is, OCC and Federal Reserve supervisors may be more prone to 'let the crisis blow over' while FDIC supervisors may instead wish to shut the institution down sooner rather than waiting in order to resolve the institution before its condition gets worse.[50] This is less of a problem for the NCUA, since it is both supervisor and insurer.

In order to resolve such imbalances in recent years, the FDIC may ask permission to examine an institution that it believes is weak against the wishes of the primary regulator.

[48] See on national depositor preference regimes e.g. http://www.shearman.com/~/media/Files/NewsInsights/Publications/2013/02/UK-FSA-and-US-FDIC-Concerned-Over-Effects-of-Nat__/Files/View-full-memo-UK-FSA-and-US-FDIC-Concerned-Over__/FileAttachment/UKFSAandUSFDICConcernedOverEffectsofNationalDepo__.pdf.

[49] https://www.fdic.gov/news/news/press/2013/pr13081.html.

[50] Such concerns became clarified in the US Thrift Crisis, in which the Federal Savings and Loan Insurance Corporation (FSLIC) was made to wait for other supervisors to shut down ailing thrifts. While supervisors dithered, those Thrifts became more deeply insolvent. By the time the mass of Thrifts was finally closed, claims to the FSLIC were so large that they rendered the FSLIC, itself, insolvent. Remaining institutions covered by the FSLIC were eventually rolled into the FDIC.

Since such access is rarely denied in normal times, the mere request in light of bank difficulties is often enough to allow the FDIC to take action.

Closing weak depository institutions in a timely manner is important because it can take a long time to resolve (sell the assets of) a failed institution. Even in modern times, **it routinely takes the FDIC – on average – about six years to fully resolve a closed depository institution.**[51]

Nonetheless, resolution authority over regulated depository institutions in the US is carried out under special statutory authority *outside* of private bankruptcy law. Without amendments to the bankruptcy law, DFA's **Orderly Liquidation Authority** may not have sufficient legal justification to be enforced. Specifically, the FDIC has the right to close banks *on behalf of investors*, not just oversee the disposition of assets in a private firm that is closed *by investors* in order to recover what remains of their investments. On the other hand, bankruptcy law has been modified to accommodate special treatments for railroads and other unique industries.[52] Thus, it is unclear whether and under what conditions such authority can be extended to non-banks.

### 2.1.6. Accountability / Due Process

In fairness, closing a depository institution is not easy. Even when the FDIC wishes to close a depository institution, the institution, itself, often fights back. Classic examples include Keystone National Bank, which filed defamation lawsuits against the OCC to forestall ongoing examinations and delay eventual closure while continuing fraudulent activities that landed bank officers in jail.[53] Similarly, officers of Hamilton Bank alleged racial discrimination instead of defamation to forestall OCC examinations. I can imagine that closing larger institutions that are less than fraudulent may cause even more – and more expensive – lawsuits.

In the first instance, banks have the right to challenge supervisory determinations. Those appeals are first reviewed by examiner supervisors.

Past that, the bank may have the right to review before an interagency board of supervisors. In 1994, all Federal agencies established a formal independent intra-agency appellate process to review material supervisory determinations regarding insured depository institutions that they supervise.[54]

Due process for bank allegations against examiners and regulatory agencies can also reach the various Inspector General (IG) offices for Federal authorities. The DFA established the *Council of Inspectors General on Financial Oversight* to facilitate communication between Inspectors General located at all of the Federal financial regulatory agencies. '*Council members share information about their ongoing work, with a focus on concerns that may*

[51] Of course, some resolutions take place quickly. Ideally, the day after a depository institution is closed a new depository institution will operate the existing branches and merge the old institution with their operations over time. Other times, the FDIC will operate a 'bridge bank' for a while to give depositors uninterrupted access to their funds and make it seem like there is no change from the outside while marketing the operations or assets of the depository institution to others. In rare instances in which the depository institution is so deeply insolvent that it cannot even be operated on a temporary basis, the FDIC must fully shut down the depository institution and pay depositors directly, requiring them to place their funds in a new depository institution, themselves.

[52] See, e.g., Lubben, Stephen G. 'Liquidation Authority and the Bankruptcy Clause,' New York Times, 25 February 2013, at http://dealbook.nytimes.com/2013/02/25/liquidation-authority-and-the-bankruptcy-clause/. As of December 1, 2014, Congress is considering a new section of the Bankruptcy Code for financial firms, but it is too early to say what the outcome of such considerations may be.

[53] After records were exhumed from a trench on one bank officer's country estate.

[54] See Section 309(a) of the Riegle Community Development and Regulatory Improvement Act of 1994 (Public Law No. 103-325, 108 Stat. 2160) ('Riegle Act'). See also http://www.fdic.gov/regulations/laws/sarc/sarcguidelines.html.

*apply to the broader financial sector and ways to improve financial oversight. The Council is made of nine financial regulatory agency Inspectors General and is chaired by the Inspector General of the US Department of Treasury*':[55]

In cases that allege violations of the Administrative Procedures Act, banks have access to the Federal Courts to resolve those more fundamental legal disputes involving regulatory powers, generally.

## 2.2. Insurance Companies

Insurance companies are informationally opaque because the insureds – who pay premiums for insurance coverage – often do not need to rely upon that coverage or check the status of the insurance company for a lengthy period of time, during which they receive little information on insurance company investments and claims payments.

While insurance company investments tend to invest in more standardized asset categories than depository institutions, insurance companies often make policy loans to insureds (in the life insurance sector) and participate in private placements of securities that may not trade across organized exchanges in a manner that produces consistent and reliable publicly available information that could allow the insured to monitor the insurance company's condition, without the help of supervisors.

### 2.2.1. General Structure

The insurance industry can be broken down into three main segments: life, property and casualty, and financial guarantee.

- **Life insurers** offer life insurance policies (including term life and whole life), annuities and reverse annuities, private pension funds, and accident and health insurance.[56]
- **Property and casualty insurance** includes fire, homeowners, automobile, and commercial insurance.
- **Financial guarantors** provide insurance for investors in financial products.

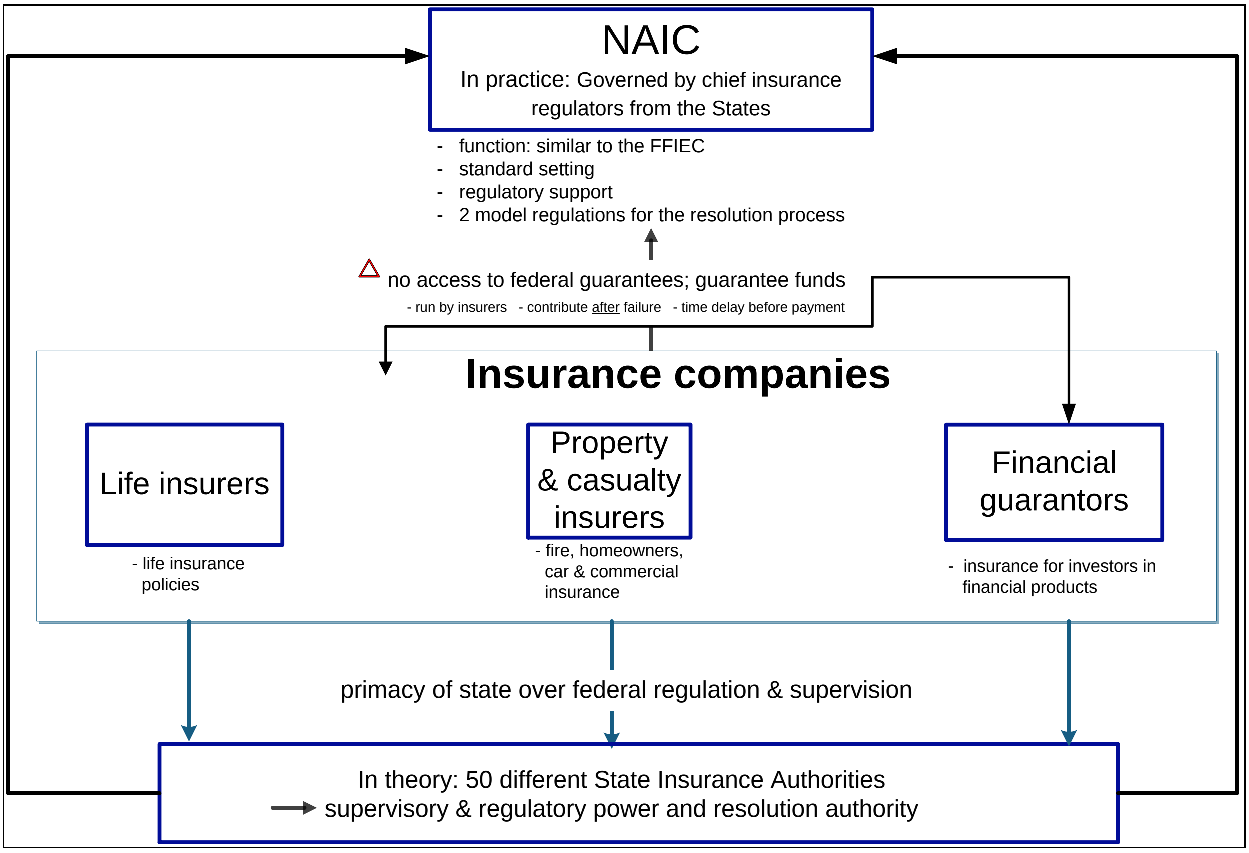
In all three segments, the insurers place premiums from those policies in market investments in order to pay out proceeds following a claim according to the terms of the contracts.[57]

[55] See http://www.treasury.gov/about/organizational-structure/ig/Pages/Council-of-Inspectors-General-on-Financial-Oversight.aspx.

[56] Life insurers also compete with securities firms to offer private pension funds.

[57] Insurance **premiums** are paid by the customer to the insurance company, while the insurance company pays **proceeds** to the insured or his beneficiaries as a result of a **claimable** event, e.g. death of the insured.

**Figure 9: Overview of Supervision, Regulation and Resolution and Guarantees of Insurance Companies**




### 2.2.2. Supervisory Bodies

The McCarran Ferguson Act of 1945 affirmed **the primacy of *state* over *federal* regulation of all forms of insurance companies. Thus, insurance companies can *only* be chartered (licensed), regulated, and supervised at the state level.**[58]

While there are, in theory, fifty different state insurance authorities, in practice those authorities coordinate supervision and regulation to a large extent through the **National Association of Insurance Commissioners (NAIC)**, which performs a function similar to the FFIEC among depository institution regulators.[59]

Insurance regulators all have **supervisory powers as well as regulatory authority**.

'*Like supervisors of depository institutions, insurance supervisors collect financial information on insurance company operations and reserve the right to directly examine day-to-day operations. Examinations consist of a process to identify and assess risk and assess the adequacy and effectiveness of strategies/controls used to mitigate risk. The process includes a determination of the quality and reliability of the corporate governance structure, risk management programs and verification of specific portions of the financial statements. Financial examiners evaluate the insurer's current strengths and weaknesses*

[58] Although Federally-chartered banks can sell insurance products (provided by insurance companies), there is no Federal authority for insurance regulation.

[59] '*The NAIC is the US* ***standard-setting*** *and* ***regulatory*** *support organization* ***created and governed by the chief insurance regulators from the 50 states****, the District of Columbia and five US territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC staff supports these efforts and represents the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the US*', see http://www.naic.org/index_about.htm.

*(e.g., board of directors, risk-management processes, audit function, information technology function, compliance with applicable laws/regulations, etc.) and prospective risk indications (e.g., business growth, earnings, capital, management competency and succession, future challenges, etc.). Then, [supervisors] document the results of the examinations in a public report that assesses the insurer's financial condition and sets forth findings of fact with regard to any material adverse findings disclosed by the examination. Examination reports may also include required corrective actions, improvements and/or recommendations.*'[60]

### 2.2.3. Funding

Like banks, insurance companies are assessed directly to fund their supervision. Companies are usually assessed a flat rate as well as a rate directly tied to the amount of effort expended in specific examinations.

Since insurance premiums are typically regulated – especially with respect to consumer property and casualty coverage – insurance companies are impeded in their ability to pass along higher supervisory costs to customers.

### 2.2.4. Resolution Process

**Insurance supervisors** also hold **resolution authority** over all forms of insurance companies in their states. The responsibility of an insurance company to pay a valid claim is an irrevocable legal obligation. Thus supervision focuses on the adequacy of financial resources with which to pay such claims.

Most existing state laws on resolution and liquidation are based on two 'model' resolution laws promulgated by the NAIC, with numerous state-specific variations. One model was the NAIC *Insurers Rehabilitation and Liquidation Model Act* (IRLA). The second is the *Uniform Insurers Liquidation Act* (UILA) approved by the National Conference of Commissioners on Uniform State Laws (in 1939) which is a statute designed to deal with the problems of administering troubled insurance companies which have assets and liabilities in more than one state. Although adopted by few sates, there was also a proposed *Uniform Receivership Law* (URL) to modernize the receivership process in the 2000s.[61]

More recently, the NAIC Insurer Receivership Model Act (MDL-555, III-555-1) has been designed to help '*protect the interests of insureds, claimants, creditors and the public generally through early detection of a potentially hazardous financial condition of an insurer and enhanced efficiency in liquidation to conserve the assets of the insurer*'. In order to adopt to the DFA Orderly Liquidation Authority, the NAIC developed the *Guideline for Implementation of State Orderly Liquidation Authority* (GDL-1700, VI-1700-1), intended '*for use by those states seeking to review their authority under existing state law for purposes of initiating rehabilitation or liquidation proceedings in accordance with*' DFA.

Because resolution proceeds according to different laws and consolidated data across states is hard to come by, there is relatively little research on insurance company resolutions. What research exists suggests that resolution costs incurred for property-liability insurance company insolvencies have been significantly larger than the costs incurred for other failed financial institutions of comparable size, with an average net cost to the guaranty associations for failed property-liability insurers of USD 1.10[62] to USD 1.22[63] for each

[60] See DeFrain.

[61] The URL was intended to be used by states participating in an interstate compact for insurer receiverships. As of 2003, however, the URL had not been adopted by any state.

[62] See Grace et al.

[63] Hall, p. 415-438.

USD 1 of assets the insurer possessed prior to bankruptcy[64] compared to around USD 0.30 per USD 1 of pre-insolvency assets for failed banks in the 1980s[65] and around USD 0.20 for failed banks in the 1990s.[66] The reasons why the cost of resolving insurance companies is so large relative to other financial institutions and what factors underlie the vast cost differences across insurers is not well understood.

### 2.2.5. Guarantee Structure

Since both the life and property and casualty sectors cater primarily to consumers, it is common for state authorities to offer guarantees of insurance proceeds in the event of a claim. Most states, therefore, promote guaranty funds to help pay the claims of financially impaired insurance companies. In their state laws they specify the types of insurance covered by these funds and the limits payable. Coverage is usually for individual policyholders and their beneficiaries (most states restrict advertising the funds' availability by insurance agents and companies). **Guarantee coverage is incredibly complex, and the extent and type of coverage vary significantly by state**.[67] While the shortcomings of the guarantee system were demonstrated fully during a widespread insurance product crisis in the US in 1990-91, which involved the failures of several large companies, little has changed since that time.[68]

**Insurers have no access to federal guarantees** (even though during the financial crisis the federal government provided support for several major insurance companies, e.g. AIG). Moreover, the guarantee funds provided by insurance authorities are very different from those extended to depository institutions. There are four key areas of differences:

- First, although these programs are '*sponsored*' or '*promoted*' by state insurance regulators, they are actually run and administered by the private insurance companies themselves.
- Second, unlike the FDIC, which establishes a reserve fund by requiring banks to pay annual premiums in excess of payouts to resolve failures, no such fund exists for the insurance industry.[69] This means that **contributions are paid into the fund by surviving firms (in a state) only after an insurance company has actually failed**.
- Third, after a failure the size of the required contributions (that surviving insurers pay to protect policyholders in the failed insurance company) differs widely from state to state. In many states each insurer is levied a *pro rata* amount, according to the size of its statewide premium income. This amount either helps pay off small policyholders[70] after the assets of the failed insurer have been liquidated or acts as a cash injection to make the acquisition of a failed insurer attractive.
- Finally, because no permanent fund exists and the annual pro rata payments to meet payouts to failed insurer policyholders are often legally capped, a **delay usually occurs before small policyholders receive the cash surrender values of their policies or other payment obligations from the fund**. This contrasts

[64] The net cost to the guaranty fund equals the total claims paid to policyholders minus the proceeds of assets sales turned over to the guaranty fund associations by the liquidator of the insurer; it does not include losses to owners and creditors of insurers with claims not covered by guaranty associations.

[65] James, p. 1223-1242.

[66] Kaufmann, Prepared testimony.

[67] See, for instance, the National Organization of Life and Health Insurance Guaranty Associations http://www.nolhga.com/factsandfigures/main.cfm/location/stateinfo.

[68] See Todd and Wallace.

[69] The sole exceptions to this rule are the property-casualty and life guarantee funds in the state of New York.

[70] The definition of small policyholders varies among states, ranging from USD 100,000 to USD 500,000.

with deposit insurance, which normally provides insured depositors *immediate* coverage of their claims up to at least USD 250,000.

**Financial guarantee companies** are supervised similarly, although while the coverage is still an irrevocable legal obligation there is no guarantee fund to back those who purchase the insurance. Still, it is rare for a financial guarantor (or any other insurance company) to be allowed to withhold payments. Nonetheless, after the mortgage crisis Financial Guarantee Insurance Corporation (better known as 'FGIC') was allowed by the Superintendent of Financial Services of the State of New York to withhold payment on some policies subject to offset (subrogation) from the liquidation of their assets and potential recoveries sought in litigation.

### 2.2.6. Accountability / Due Process

While not governed by rules of Federal regulatory procedure outlined in the Administrative Procedures Act, state insurance regulators tend to maintain consistency with such rules by creating regulations in an open environment subject to public input and hearings. **State administrative law sections typically resolve disputes between insurance companies and their regulators**.

## 2.3. Capital Markets Institutions

While capital markets institutions are a bit less informationally opaque (both institutional and individual investors are usually more sophisticated than bank depositors and regularly receive information about their holdings), supervision is still useful to make sure that certain elements of financial markets that are more difficult for investors to monitor continue to work smoothly and efficiently (see Box 5.).

**Box 5: Broker-dealer violations (Madoff)**

**The Madoff Fraud**

According to the SEC indictment against Madoff, staff created false trading reports based on the returns that Bernard Madoff ordered for each customer. For example, once Mr. Madoff determined a customer's desired return, one of the back office workers would enter a false trade from a previous date and then enter a false closing trade in the amount of the required profit in order to generate that return, regardless of actual customer trades.

In spite of the falsified records, none of the money was actually invested. Mr Madoff admitted during his March 2009 guilty plea that he just held the money in an account at JP Morgan Chase. When clients wanted their money, '*I used the money in the Chase Manhattan bank account that belonged to them or other clients to pay the requested funds*' he told the court.[71]

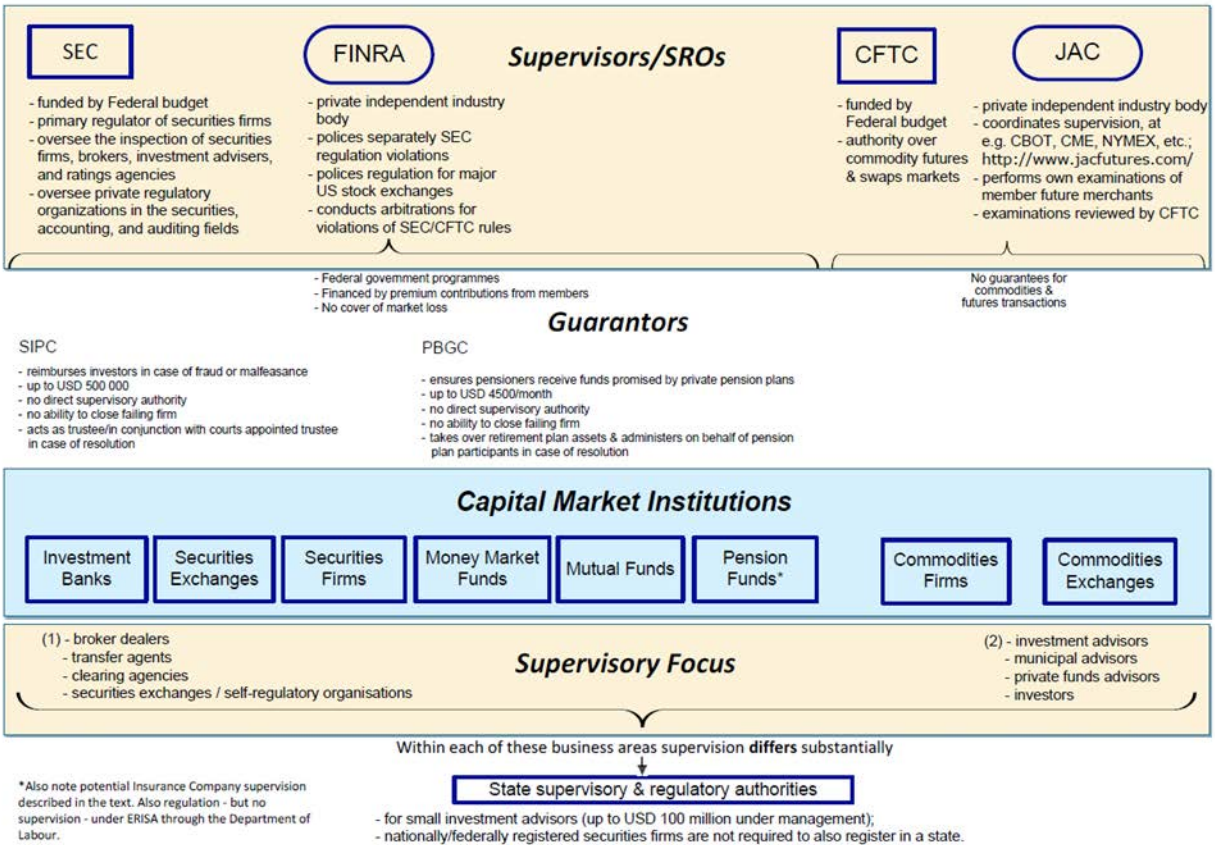
### 2.3.1. General Structure

**Capital markets institutions** generally include **investment banks, securities and commodities firms, mutual funds, and pension funds**, as well as the organized **exchanges** upon which trades of related financial instruments take place.[72] While capital markets institutions are heavily *regulated* via strict licensing procedures and reporting requirements for investor holdings, only securities and commodities firms - those primarily focusing on securities trading and investment advice - are directly *supervised* with on-site examination and monitoring. Moreover, **unlike banks such supervision is more procedural than prescriptive** – that is, regulators focus on keeping things working smoothly instead of constraining the risk of products sold and traded in the markets.

[71] See e.g. 'Two Charged With Helping Madoff Make Fake Trades', *National Public Radio;* 18 November 2010; as well as Steinert-Threlkeld; and Stempel.

[72] Private pension funds are provided by both securities firms and insurance companies. I treat them here for convenience.

**Figure 10: Overview of Supervision, Regulation, Resolution and Guarantees of Capital Market Institutions in Practice**




Nonetheless, **securities and commodities firms** are supervised on-site in order to ensure that basic operations involved in sales and trading are carried out in a smooth manner that protects market participants – particularly individual investors – from fraud or malfeasance.[73] Typically, elements of the system regarding the purchase and sale of financial instruments are *supervised* to ensure that securities transactions ordered by investors are carried out in a timely and complete fashion. Additionally, elements of the system regarding investment advice are *supervised* to ensure that conflicts of interest – such as payment by firms for specific advice or providing advice contrary to investors' interests – do not arise.

[73] '*The Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940 authorize the SEC to conduct examinations of firms that are registered with the SEC, including registered broker-dealers, transfer agents, clearing agencies, investment advisers, and investment companies. [...] The purpose of SEC examinations is to protect investors.*' See http://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf. '*Congress created the Commodity Futures Trading Commission (CFTC) in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. The CFTC's mission is to protect market users and the public from fraud, manipulation, abusive practices and systemic risk related to derivatives that are subject to the Commodity Exchange Act, and to foster open, competitive, and financially sound markets.*', see http://www.cftc.gov/About/MissionResponsibilities/index.htm.

**Box 6: Transparency (Money Market Fund Regulation)**

**Transparency and Money Market Fund Regulation**

Money market funds (MMFs) are established with the condition that they

(i) restrict investments to 'known' liquid investments and, as a result,

(ii) do not have to report the market value of those investments publicly, but have that certified by rating agencies and report investments at par value.

In so doing, MMFs are similar to the concept advanced in the 1990s of 'narrow' banks, which invest in strictly defined asset classes yet promise investors redemption at par (with a small rate of return). As in banking history, MMFs occasionally fail to maintain assets of sufficient value to redeem investor claims at par, at least in the short term.

Concerns about MMF transparency have led to the present debates about regulation. While MMFs in recent years have been required by the SEC to increase redemption reserves, bank regulators like the Federal Reserve would have them report market value rather than par value of investments in order to allow investors to monitor value more closely than under current regulations.

Moreover, in a classic regulatory conflict the SEC, which has historically been the primary regulatory authority for MMFs, continues to argue that its primacy of regulation in the area – as well as recent reforms passed by the SEC in 2010 – should not be subjected to outside regulatory interference.[74]

### 2.3.2. Supervisory Bodies

The Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) *supervise* two main areas of the industry involving securities and commodities firms (using the language of the SEC):

- **broker-dealers**, transfer agents, clearing agencies, and **securities exchanges**/self-regulatory organizations (SROs);
- **investment advisers**, municipal advisers, private fund advisers, and **investors**.[75]

Within each of those areas, supervisory authority and other details differ substantially.

The focus with respect to broker-dealers, transfer agents, clearing agencies, and securities exchanges/SROs by both the SEC and CFTC is largely on the clearing and settlement of securities and commodities trades. For instance, with respect to the SEC, trades should be executed in the order in which they are received (no front-running) and securities must be delivered to buyers in a timely manner. Obviously, broker-dealers have to buy the securities they claim to purchase on behalf of customers (see Box 5).

[74] See Borak.

[75] DFA extended supervisory authority to ratings agencies (NRSROs). Since rules for on-site examination have not been promulgated, I do not discuss those here but would tend to include such rules in the same general category of examination authority over investment advice. To date, supervision relating to NRSROs has historically involved registering rating agencies for producing ratings on different product classes and assessing historical rating performance by ensuring that annual reports are made available to the public. The registration process is focused on ensuring there exist, '*adequate financial and managerial resources to consistently produce credit ratings with integrity*' (see Credit Rating Agency Reform Act of 2006, http://www.sec.gov/divisions/marketreg/ratingagency/cra-reform-act-2006.pdf). New requirements under DFA may include additional reporting on internal controls, protecting against conflicts of interest, establishing professional standards for credit analysts, publicly providing – along with the publication of the credit rating – disclosure about the credit rating and the methodology used to determine it, enhancing credit rating agency public disclosures about the performance of their credit ratings, and disclosure concerning third-party due diligence reports for asset-backed securities (see '*SEC Proposes Rules to Increase Transparency and Improve Integrity of Credit Ratings*', Press Release 2011-113, 18 May 2011 at http://www.sec.gov/news/press/2011/2011-113.htm). Most of that, however, involves greater *reporting* but not on-site *supervision* like that carried out in broker-dealer examinations.

**Box 7: Investment Advice Violations**

**Securities Lending Investments in SIVs**

Alleged violations of SEC regulations in the area of investment advice and guidance are currently being pursued in the securities lending market. There, some participants allege that they did not approve of investments in certain types of commercial paper funding *Structured Investment Vehicles* (SIVs) backed in part by US mortgages. In those cases, there exists adequate information about the investments and the contracts involved for investors to bring charges and for courts to weigh on the matters.

Thus, unlike the high asymmetric information depository institution and insurance sectors where investors have little understanding of the investments made with their funds, sectors placing sophisticated investor money into transparent funds typically do not need to invoke on-site supervision to maintain safety and soundness, but allow individual investors access to (collective or individual) legal remedies that they can invoke on their own in the event they perceive a violation of their contractual arrangements.

For SROs governed by the CFTC, the **Joint Audit Committee** (JAC) operates as a private sector equivalent to the FFIEC for bank regulators. '*The Joint Audit Committee is a representative committee of US futures exchanges and regulatory organizations including the ACC, BTEC, CBOT, CME, COMEX, CSC, ELX Futures, KCBOT, MESL, MGE, NQLX, NYCE, NYFE, NYMEX, One Chicago, PBOT, and the NFA. The committee's primary responsibility is to oversee the implementation and functioning of the Joint Audit Agreement and to determine the practices and procedures to be followed by each DRSO in conducting audits and financial reviews of FCMs.*'[76] The JAC undertakes its own examinations of member futures commission merchants '*to meet the goals of customer protection and exchange financial integrity to meet the goals of customer protection and exchange financial integrity*' which are reviewed by the CFTC. '*The CFTC may, at its discretion, perform its own examination of an FCM.*'[77]

Much of the oversight is similar to that provided in the **US payments system**, in which checks, credit card charges, and small and large balance electronic payments are cleared and settled. Without a single central bank clearing securities transactions (as the central bank does with payments), however, the SEC supervises operations to ensure that individual securities firms maintain compliance with necessary rules and procedures.

SEC supervision with regard to **market advice** targets not only **investment advisors**, but also potentially **investors** who may attempt to influence markets in ways that violate securities laws and regulations. Investment advisors must be licensed and issue advice to investors on proper terms. Additionally, they must properly segregate funds in different customer accounts so that customer redemptions can be remitted on a timely basis.

The National Securities Markets Improvement Act (NSMIA) of 1996 reaffirmed the **SEC as the primary regulator of securities firms**. According to the NSMIA, states are not allowed to require federally registered securities firms to be registered in a state as well. States are also prohibited from requiring registrations of securities firms' transactions and from imposing other substantial requirements on private placements. Still, states regulate small investment advisors with assets under management of under USD 100 million, while the SEC regulates large investment advisors.

In addition to the SEC and CFTC, a private independent industry body, the **Financial Industry Regulatory Authority, Inc. (FINRA)**, separately polices the securities industry for SEC regulatory violations.[78] FINRA monitors trading abuses like insider trading, trading

[76] See http://www.marketswiki.com/mwiki/Joint_Audit_Committee; Joint Audit Committee website http://www.jacfutures.com/jac/Default.aspx.

[77] http://www.cmegroup.com/clearing/audit/joint-audit-committee.html.

[78] For example, on 22 May 2012, FINRA '*fined Citigroup USD 35 million for alleged rule violations, including providing investors with inaccurate information in connection with several RMBS offerings. Citigroup consented to the USD 35 million fine, but neither admitted nor denied FINRA's findings. FINRA found that between January of 2006 and October of 2007, Citigroup posted inaccurate performance data and static pool*

rule violations[79], and securities firm capital levels.[80] FINRA also performs market regulation under contract for the major US stock exchanges.

Special rules apply in the US **municipal securities market** (e.g. for tax-exempt and taxable municipal bonds, municipal notes, and other securities issued by states, cities, and counties or their agencies to finance public projects or for other public policy purposes). Congress generally exempted issuers of municipal securities or other municipal entities from most provisions of the federal securities laws otherwise applicable to private-sector issuers of corporate and other types of securities.

The **Municipal Securities Rulemaking Board (MSRB)**[81] is another self-regulatory organization. MSRB issues investor protection **rules** and other rules regulating broker-dealers', banks', and municipal advisors' activities in this market designed '*to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, and processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest.*'.[82] However, MSRB rules do not cover *issuers* of municipal securities.

MSRB is subject to **oversight** by the SEC. Its rules are enforced by various other federal regulatory organizations (SEC, FINRA, the Fed, FDIC and OCC).

### 2.3.3. Funding

The SEC and CFTC are funded by annual appropriations from the Federal budget. Both agencies have faced budget declines as demand for their services has risen as a result of the financial crisis. While the SEC collects roughly twice the annual revenue awarded in Congressional appropriations through registration fees and civil penalties from its enforcement actions, those are remanded to the US Treasury, not kept at the SEC. Recent changes to financial regulations under DFA have reinvigorated the debate about funding the SEC on-budget or through its own user fees.[83] In addition, as mentioned before, the CFTC has to be regularly re-authorized, while being similarly constrained by the appropriations process.

### 2.3.4. Guarantee Structure

There are two sorts of guarantees provided in the securities industry. First, the **Securities Investor Protection Corporation (SIPC)** reimburses investors for losses arising from fraud or malfeasance. Second, the **Pension Benefit Guarantee Corporation (PBGC)**

---

*information on its website after receiving information indicating that the data was incorrect. The agency further found that the errors in the information were significant enough potentially to have affected prospective investors' assessments of six subprime and Alt-A RMBS offerings. Additionally, the organization found that Citigroup failed to maintain required books and records and failed to supervise the pricing of certain CDO securities, violating, among other things, SEC Rules 17(a)-3(a)(8) and 17a-4.*'; see http://blogs.orrick.com/financial/2012/05/29/finra-fines-citigroup-35-million-for-violation-of-finra-and-sec-rules/.

79 For example, in July 2003, the NYSE fined a veteran floor trader at Fleet Specialist Inc. USD 25,000 for allegedly mishandling customer orders in General Motors stock. As a specialist, the trader was supposed to buy and sell for all customers on the floor. When General motors stock fell sharply on 27 June 2002 after rumors circulated that the auto maker had accounting problems, the trader sold 10,000 shares from Fleet's own account when another known seller was on the floor, instead of buying the stock from that seller in his role as a specialist.

80 Securities firms are required to hold a minimum 2 % net worth to assets capital ratio.

81 http://www.msrb.org/.

82 For instance, MSRB, just as the SEC, has adopted a *Pay to Play rule* (Rule G-37), aiming to eliminate the use of political contributions to obtain municipal underwriting business from state and local governments.

83 See e.g. Johnson.

insures that pensioners receive funds promised to them from private pension plans. Both are Federal government programs. The SIPC was created following the passage of the Securities Investor Protection Act in 1970 and is financed by premium contributions from member firms. The PBGC was created in 1974 as part of the Employee Retirement Income Security Act and is financed by premiums paid by employers offering private pension plans.[84]

The SIPC guarantees investors for up to USD 500,000 (including up to USD 250,000 for cash in the investor's account) in the case of failures of broker-dealers or investment advisors due to fraud or malfeasance.[85] While the SIPC guaranty covers money market, mutual, and hedge funds, generally, they do not cover market losses in those funds.

If a pension plan is terminated without sufficient money to pay all the benefits it promised, PBGC's insurance program will pay employees the benefit provided by the pension plan up to the limits set by law. For plans that ended in 2010 and 2011, workers who retire at age 65 can receive up to USD 4,500 a month (USD 54,000 a year). While the PBGC covers the possibility that a private pension plan may not be there for the pensioner when they retire, it does not cover market losses to defined contribution plans (in which employees invest their own money), only defined benefit plans (those that firms promise their employees).

Some mutual funds purchase private guarantees to cover probable market loss. Such guarantees are not required by law, but are merely a private arrangement made as a selling point for the fund.

There are no guarantees on commodities and futures transactions. Rather, market arrangements rely on a system by which margin must be posted by counterparties against the difference in value on a daily basis. In that way, there can be no more than one day's value change that is not secured by the margin value.

### 2.3.5. Resolution Process

The SIPC acts in a resolution capacity as trustee or in conjunction with a court-appointed trustee to recover missing assets in failed securities firms. Under the law governing the SIPC, customers of a failed brokerage firm take legal possession of all non-negotiable securities that are already registered in their names or in the process of being registered. All '*street name*' securities – those registered in the name of the securities firm – are distributed among customers on a *pro rata* basis. Funds from the SIPC reserve are available to satisfy the remaining claims of each customer up to a maximum of USD 500,000. Surplus recoveries are used to pay investors whose claims exceed SIPC's protection limit of USD 500,000.[86]

The PBGC similarly takes over retirement plan assets (and obligations) of companies that fail and administers those assets on behalf of pension plan participants.[87] Plan participants have no direct claim to the assets, but receive their scheduled plan payout up to the limits of the PBGC guarantees.

---

[84] The PBGC was significantly underfunded from its inception through when it was first reformed by the 1994 Retirement Protection Act, which raised premiums and allowed the PBGC to operate at a surplus in 2000. The 2006 Pension Protection Act raised employer premiums further. The PBGC now charges employers between USD 9 and USD 35 per employee per annum for coverage. Those rates can increase up to USD 1,000 in the event the employer's pension plan is currently underfunded.

[85] See http://www.sipc.org/about-sipc/sipc-mission.

[86] See http://www.sipc.org/Who.aspx.

[87] For example, in 2005 the PBGC assumed control of two bankrupt airlines' pension plans. The US Airways and United pension plans were estimated to be underfunded by USD 726 million and USD 1,400 million, respectively. Both were covered by PBGC.

**Neither the SIPC nor the PBGC, themselves, have the ability to close a failing firm. Rather, they merely cover the losses to investors**. The PBGC has no direct supervisory authority or regulatory power over the pension plans it guarantees.[88]

Commodity brokers and clearing organizations are **liquidated** (not put into conservatorship) under Chapter 7 of the Bankruptcy Code and CFTC 17 CFR 190[89] or (potentially) federal court equity receivership.[90] The Bankruptcy Code of 1978 provides **safe harbors** (special treatment) **for commodity and futures market participants** using qualified financial contracts (QFCs) like securities contracts; forward contracts; commodity contracts' repurchase agreements; swap agreements; and **master netting agreements**. Those protect, specifically, stockbrokers and securities clearing agencies; forward contract merchants; commodity brokers (including derivatives clearing organizations); repo participants; swap participants; financial institutions; and financial participants. '*Taken together, this special treatment of derivative counterparties puts them in a much stronger position than regular creditors. While they do not have priority in the strict legal sense, their special rights relative to other creditors make derivative counterparties effectively senior, at least to the extent that they are collateralized. In practice, this collateralization is usually ensured via regular marking to market and collateral calls*'.[91]

### 2.3.6. Accountability / Due Process

Like other supervisors, the SEC and CFTC can bring sanctions against securities firms, licensed securities market participants, futures commission merchants, and exchanges. If participants object, SEC and CFTC allegations can be subjected to administrative law proceedings. Hearings are conducted at various locations throughout the United States. Upon hearing the case, the administrative law judge prepares an initial decision that includes factual findings, legal conclusions, and, where appropriate, orders relief.[92]

Typical sanctions include suspending or revoking the registrations of registered securities, as well as the registrations of brokers, dealers, investment companies, investment advisers, municipal securities dealers, municipal advisors, transfer agents, and nationally recognized statistical rating organizations. In addition, sanctions '*can order disgorgement of ill-gotten gains, civil penalties, censures, and cease-and-desist orders against these entities, as well as individuals, and can suspend or bar persons from association with these entities or from participating in an offering of a penny stock*'.[93]

---

88 Although those plans are governed by ERISA, which imposes legal fiduciary obligations on employers providing such plans on behalf of employees.

89 Section 713(c) of the Dodd-Frank Act amends the CEA to add, as section 20(c) thereof, a provision that requires the CFTC to exercise its authority to clarify the legal status, in the event of a commodity broker bankruptcy, of (i) securities in a portfolio margining account held as a futures account, and (ii) an owner of such account, see http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-26479a.pdf.

90 See presentation of Robert S. Steigerwald, 'FMU Recovery and Resolution: "Orderly Liquidation" in the Shadow of the Bankruptcy Code' Federal Reserve Bank of Chicago, August 22, 2012.

91 Patrick Bolton & Martin Oehmke, *Should Derivatives Be Privileged in Bankruptcy?,* 5 March 2012. See also, Committee on Payment and Settlement Systems (CPSS) and Technical Committee of the International Organization of Securities Commissions (IOSCO), Principles for financial market infrastructures (April 2012).

92 See, e.g., Office of Administrative Law Judges at http://www.sec.gov/alj.shtml; regarding the discussion on the use of administrative and Cease-and-Desist Proceedings see the remarks of Andrew Ceresney, Director, SEC Division of Enforcement, to the American Bar Association's Business Law Section Fall Meeting , Washington D.C., 21 November 2014; http://www.sec.gov/News/Speech/Detail/Speech/1370543515297.

93 See, e.g., Office of Administrative Law Judges at http://www.sec.gov/alj.shtml.

Parties may **appeal an initial decision to the SEC or CFTC**, which performs a *de novo* review and can affirm, reverse, modify, set aside, or remand for further proceedings. **Appeals from Commission action are to a United States Court of Appeals**.[94]

In the US, parties can many times agree to settle matters by **arbitration** rather than in the courts. Most of such arbitrations with respect to regulatory and supervisory violations for both SEC and CFTC are carried out through FINRA.[95]

**FINRA arbitration panels** are composed of one or three arbitrators who are selected by the parties. The panel's decision, called an 'award,' is final and binding on all the parties, subject to judicial appeal.

**One advantage of FINRA arbitration is that arbitration is generally confidential. Thus, unlike court-related filings, documents submitted in arbitration are not made public.** However, if an award is issued, FINRA posts the award on its public Arbitration Awards Online Database.

94 See, e.g., Office of Administrative Law Judges at http://www.sec.gov/alj.shtml.

95 See, e.g., http://www.finra.org/ArbitrationAndMediation/index.htm.

**Table 3: Capital Markets Institutions, their Activities and Supervision**

Capital Markets Institutions

| | Mergers & Acquisitions | Underwrite and Distribute Equity and Debt | Market Making | Trading / Clearing & Settlement | Custody / Escrow | Cash Management Accounts | Investing on Behalf of Others / Advice |
|---|---|---|---|---|---|---|---|
| Investment Banks | x | x | x | x | x | x | x |
| Securities Firms | | distribution only | x | x | x | x | x |
| Mutual Funds | | | | | | x | x |
| Hedge Funds | | | | | | | x |
| Pension Funds | | | | | | | x |
| Supervision | None | None | SEC Supervises Broker Dealers, Transfer Agents, Clearing Agencies, and Security Exchanges / SROs to ensure that securities paid for by investors are delivered and held on their behalf. Focus is on clearing and settlemen of securities trades, i.e., trades should be executed in the order in which they are received and securities must be delivered to buyers in a timely manner. | | | | SEC Supervises Investment Advisors, Municipal Advisors, Private Fund Advisors, and Investors to ensure Advice is unbiased and accurate. Focus is with respect to market advice, i.e., ensuring investors receive accurate information and also that no investors attempt to influence markets. |
| Guarantee System | | | | SIPC Reimburses Investors for losses from fraud and malfeasance, not market loss.<br>PBGC insures pensioners receive funds promised to them by private pension plans.<br>Both funded by investor contributions. | | | |
| Enforcement | | | | SEC may enforce its own sueprvisory violations<br>FINRA enforces regulatory violations, but has no supervisory authority<br>State securities regulators primarily rely upon state attorneys general to prosecute SEC regulatory violations, but have no supervisory powers. | | | |

# 3. SUMMARY AND CONCLUSION

In summary, the present note defines supervision and regulation as practiced in the US and provides a concise overview of US supervisory authorities. This note offers three main conclusions.

1. The US legal system allows prescriptive financial supervision to be limited to financial institutions and products that (individual and institutional) investors cannot comprehend on the basis of published financial reports produced according to commonly accepted accounting standards – institutions referred to economically as 'informationally opaque.' For securities and commodities markets, including securities and commodities exchanges, looser 'procedural' supervision is imposed to ensure smooth functions in financial markets.

   Where standard reporting is sufficient for understanding an investment, legal mechanisms like private lawsuits, class action litigation (collective redress), and lawsuits filed by the US Department of Justice and/or State Attorneys General can be relied upon to incentivize compliance and punish infractions. Similarly, the regular bankruptcy code is relied upon to resolve institutions like securities and commodities firms, where (unlike banks) the financial instruments they hold can be priced and sold on liquid markets. If the EU (or Member States) has a different legal and bankruptcy framework, the boundaries of supervision and regulation may differ substantially from those applied in the US.

2. Because of US historical background it has been popular in the US to direct greater financial supervision to depository institutions (commercial banks, thrifts, and credit unions) than other financial institutions like investment funds or securities markets. Colonists in the Americas disliked financial institutions and inhibited bank growth, most importantly by limiting banks to a single office and preventing them from participating in 'non-bank' and other commercial activities.

3. US supervision has historically been targeted to certain types of *legal* entities – banks, thrifts, and credit unions as defined by the law – rather than the parent companies of those entities, which were only formally recognized in 1956. Moreover the strict adherence to a Holding Company form of organization for those parent companies further limits direct comparison of US arrangements with EU objectives.

In sum, the US supervisory construct is laid over a legal and government framework that differs substantially from that of the EU and its individual countries. **So while it may be interesting and useful to see what lessons can be learned from the US, the usefulness of those has to be weighed against the institutional (including government, legal, and social) similarities - or differences - in the US and EU.**

# REFERENCES


- Balla, Eliana; Rose, Morgan J.; and Romero, Jessie, 'Loan Loss Reserve Accounting and Bank Behavior,' Federal Reserve Bank of Richmond *Economic Brief*, March 2012.
- Barnett Bank of Marion County, N.A., Petitioner, v. Bill Nelson, Florida Insurance Commissioner, et al.; http://www.law.cornell.edu/supremecourt/text/517/25.
- Basel Committee on Banking Supervision, 'Pillar II (Supervisory Review Process),' Consultative Document, 31 May 2001 at http://www.bis.org/publ/bcbsca08.pdf.
- Borak, Dana, 'Money Fund Industry Tells FSOC to Back Off.' *American Banker*, 26 February 2013.
- CFTC Reauthorization Bill (H.R. 4413 Customer Protection and End User Relief Act; https://www.congress.gov/bill/113th-congress/house-bill/4413?q=%7B%22search%22%3A%5B%22hr+4413%22%5D%7D.
- CME Group website at http://www.cmegroup.com/market-regulation/regulation-of-clearing-members/joint-audit-committee.html.
- Code of Federal Regulations, http://www.gpo.gov/fdsys/browse/collectionCfr.action?collectionCode=CFR.
- Council of Inspectors General on Financial Oversight, http://www.treasury.gov/about/organizational-structure/ig/Pages/Council-of-Inspectors-General-on-Financial-Oversight.aspx.
- Credit Rating Agency Reform Act of 2006, http://www.sec.gov/divisions/marketreg/ratingagency/cra-reform-act-2006.pdf.
- Dash, Eric, and Sorkin, Andrew Ross. 'Government Seizes WaMu and Sells Some Assets,' *New York Times*, 25 September 2008; http://www.nytimes.com/2008/09/26/business/26wamu.html?pagewanted=all&_r=0.
- Davis Polk & Wardwell LLP, Client Memorandum 'Swaps Pushout Rule: Federal Reserve Clarifies Treatment of U.S. Branches of Foreign Banks,' 6 June 2013; http://www.davispolk.com/download.php?file=sites/default/files/files/Publication/a5c89ca4-1bc3-457f-9de6-864d4bef7cdb/Preview/PublicationAttachment/b4d5290a-be79-4a92-be3c-86b1cfedb84e/06.06.13.Swaps.Pushout.pdf.
- DeFrain, Kris. *US Insurance Financial Regulatory Oversight and the Role of Capital Requirements*, NAIC Center for Insurance and Policy Research, January 2012; http://www.naic.org/cipr_newsletter_archive/vol2_oversight.htm.
- Dudley, Susan, and Brito, Jerry; Primer on Regulation, 6 December 2005, update 14 August 2012; http://mercatus.org/publication/regulation-primer.
- Federal Deposit Insurance Corporation, *History of the Eighties—Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s*, 1997 http://www.fdic.gov/bank/historical/history/index.html.
- Federal Deposit Insurance Corporation, *Managing the Crisis: The FDIC and RTC Experience,* 1998 http://www.fdic.gov/bank/historical/managing/index.html.
- Federal Reserve Bank of San Francisco, http://www.frbsf.org/what-is-the-fed/supervision_regulation.html.
- *Federal Reserve Board reaches over SEC for US broker-dealers of foreign banking organizations,* 23 January 2013, http://www.lexology.com/library/detail.aspx?g=a590e8f1-bc66-4cd7-98f8-558b4fcad64a.

- Federal Reserve Board, Annual Report 2010, Banking Supervision and Regulation; http://www.federalreserve.gov/publications/annual-report/2010-banking-supervision-regulation.htm.
- *Federal Reserve Introduces New BHC Rating System*; http://www.stlouisfed.org/publications/cb/articles/?id=835.
- FFIEC website http://www.ffiec.gov/about.htm.
- FINRA Arbitration and Mediation; http://www.finra.org/ArbitrationAndMediation/index.htm.
- FINRA Fines Citigroup $35 Million for Violation of FINRA and SEC Rules; http://blogs.orrick.com/financial/2012/05/29/finra-fines-citigroup-35-million-for-violation-of-finra-and-sec-rules/.
- GAO Report 11-612, *Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness*; http://www.gao.gov/new.items/d11612.pdf.
- GAO Report to Congressional Committees, *National Credit Union Administration: Earlier Actions are Needed to Better Address Troubled Credit Unions*, January 2012; http://www.gao.gov/assets/590/587409.pdf.
- Global Plan Annex: Declaration on Strengthening the Financial System, Statement Issued by the G20 Leaders, London, 2 April 2009; http://www.g20.utoronto.ca/2009/2009ifi.html.
- Grace, Martin F.; Klein, Robert W.; and Phillips, Richard D., Insurance Company Failures: Why Do They Cost So Much?, Wharton Financial Institutions Center Working Paper 03-22, October 2003; http://fic.wharton.upenn.edu/fic/papers/03/0332.pdf.
- Hall, Brian J., Regulatory Free Cash Flow and the High Cost of Insurance Company Failures, *Journal of Risk and Insurance* 67(3), 2000, p. 415.
- Investment Advisers Act of 1940 http://www.sec.gov/about/laws/iaa40.pdf.
- Investment Company Act of 1940 http://www.sec.gov/about/laws/ica40.pdf.
- James, Christopher, 1991, The Losses Realized in Bank Failures, *Journal of Finance* 46(4): 1223-1242.
- Johnson, Fawn. Senator, Regulators Call for SEC Self-Funding in Financial Bill, *Wall Street Journal*, 15 April 2010; http://online.wsj.com/article/SB10001424052702304510004575185992343231872.html.
- Joint Audit Committee website at http://www.wjammer.com/jac/.
- Kaufmann, George G., *Prepared testimony of George G. Kaufmann for the US Senate Committee on Banking, Housing and Urban Affairs*, 11 September 2001, http://www.senate.gov/~banking/01_09hrg/091101/kaufman.htm.
- Lubben, Stephen G., *Liquidation Authority and the Bankruptcy Clause*, New York Times, 25 February 2013, http://dealbook.nytimes.com/2013/02/25/liquidation-authority-and-the-bankruptcy-clause/.
- Murphy, Edward V. *Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets*, Congressional Research Service, 28 May 2013; http://www.fas.org/sgp/crs/misc/R43087.pdf.
- NAIC website, http://www.naic.org/index_about.htm.
- National Organization of Life and Health Insurance Guaranty Associations, http://www.nolhga.com/factsandfigures/main.cfm/location/stateinfo.
- Office of the Inspector General - Department of the Treasury, http://www.treasury.gov/about/organizational-structure/ig/Pages/default.aspx.

- Parker, Richard, and Alemanno, Alberto; Towards Effective Regulatory Cooperation under TTIP: A Comparative Overview of the EU and US Legislative and Regulatory Systems, European Commission, Brussels, 13 May 2014; http://trade.ec.europa.eu/doclib/docs/2014/may/tradoc_152466.pdf.
- Bolton, Patrick and Oehmke, Martin, Should Derivatives Be Privileged in Bankruptcy? (March 5, 2012).
- Patterson, Scott. 'New Delay for Volcker Rule.' *New York Times*, 28 February 2013.
- Peirce, Hester, and Greene, Robert, The Federal Reserve's Expanding Regulatory Umbrella, Mercatus Center, George Mason University, April 2013; http://mercatus.org/sites/default/files/Peirce-Fed-Regulatory-Umbrella.pdf.
- Pittman, Mark. 'Subprime Securities Market Began as `Group of 5' Over Chinese Food', *Bloomberg*, 17 December 2007; http://www.bloomberg.com/apps/news?sid=aA6YC1xKUoek&pid=newsarchive.
- Steigerwald, Robert S., 'FMU Recovery and Resolution: "Orderly Liquidation" in the Shadow of the Bankruptcy Code', Presentation at the Federal Reserve Bank of Chicago, 22 August 2012.
- *Report of Inspection for Citigroup, Inc., as of December 31, 2007*. Federal Reserve Bank of New York, 15 April 2008. http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-04-15_FRBNY_Letter_from_John_J_Ruocco_to_Board_of_Directors_of_Citigroup_Re_Annual_report_of_inspection.pdf
- *Report of Inspection for Citigroup, Inc., as of December 31, 2008*. Federal Reserve Bank of New York, 14 January 2009. http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2009-01-14%20FRBNY%20Summary%20of%20Supervisory%20Activity%20and%20Findings%20on%20Citi.pdf
- Riegle Community Development and Regulatory Improvement Act, Section 309(a) 1994 (Public Law No. 103-325, 108 Stat. 2160).
- Securities and Exchange Commission Examination Brochure http://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf.
- Securities and Exchange Commission Office of Administrative Law Judges http://www.sec.gov/alj.shtml.
- Securities and Exchange Commission, 'SEC Proposes Rules to Increase Transparency and Improve Integrity of Credit Ratings,' Press Release 2011-113, May 18, 2011 at http://www.sec.gov/news/press/2011/2011-113.htm.
- Securities Exchange Act of 1934 http://www.sec.gov/about/laws/sea34.pdf.
- SIPC: Who We Are http://www.sipc.org/Who.aspx.
- Smale, Pauline; Structure and Functions of the Federal Reserve System, Congressional Research Service, 10 November 2010; http://fpc.state.gov/documents/organization/151977.pdf.
- Steinert-Threlkeld, Tom. 'Women of the House of Madoff'. *Securities Technology Monitor*. 18 November 2010.
- Stempel, Jonathan. 'Madoff trustee sues JPMorgan for USD 6.4 billion'. *Reuters*. 2 December 2010.
- Supervision Appeals Review Committee Guidelines, http://www.fdic.gov/regulations/laws/sarc/sarcguidelines.html.
- Supervision Manuals - Board of Governors of the Federal Reserve http://www.federalreserve.gov/boarddocs/supmanual/.

- Technical Committee of the International Organization of Securities Commissions (IOSCO), Principles for financial market infrastructures (April 2012).
- Todd, Richard M. and Wallace, Neil, 'SPDAs and GICs: Like Money in the Bank?', Federal Reserve Bank of Minneapolis *Quarterly Review*, Summer 1992, http://www.minneapolisfed.org/research/qr/qr1631.pdf.
- 'Two Charged With Helping Madoff Make Fake Trades'. *NPR*. 18 November 2010.
- US Code of Federal Regulations, 12 CFR §6, Prompt Corrective Action, at http://cfr.regstoday.com/12cfr6.aspx.
- US Code of Federal Regulations, 12 CFR Ch. 11 §268.205, Access to Sensitive Information.
- US Office of the Comptroller of the Currency, http://occ.treas.gov/topics/licensing/index-licensing.html.
- US Office of the Comptroller of the Currency, http://www.helpwithmybank.gov/complaints/index-file-a-bank-complaint.html.
- US Office of the Comptroller of the Currency, 'OCC Bulletin 2008-20: Final Guidance on Supervisory Review Process,' 31 July 2008 (at http://www.occ.gov/news-issuances/bulletins/2008/bulletin-2008-20.html).
- US Office of the Comptroller of the Currency, *Comptroller's Handbook,* http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/index-comptrollers-handbook.html.
- Vartanian Thomas P. 'How to Combat Bad Agency Decisions.' *American Banker*, 14 February 2013, p. 8.
- World Bank, Bank Regulation and Supervision Survey and Databases, at http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20345037~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html.
- Yandle, Bruce and Adams, Mark, Regulatory Flexibility: How to Mitigate the Effects of Katrina and Other Disasters, September 2010; http://mercatus.org/sites/default/files/publication/Regulatory_Flexibility.pdf.

# ANNEX - Supplementary figures

**Figure 11: Overview of Supervision and Regulation of Financial Institutions**

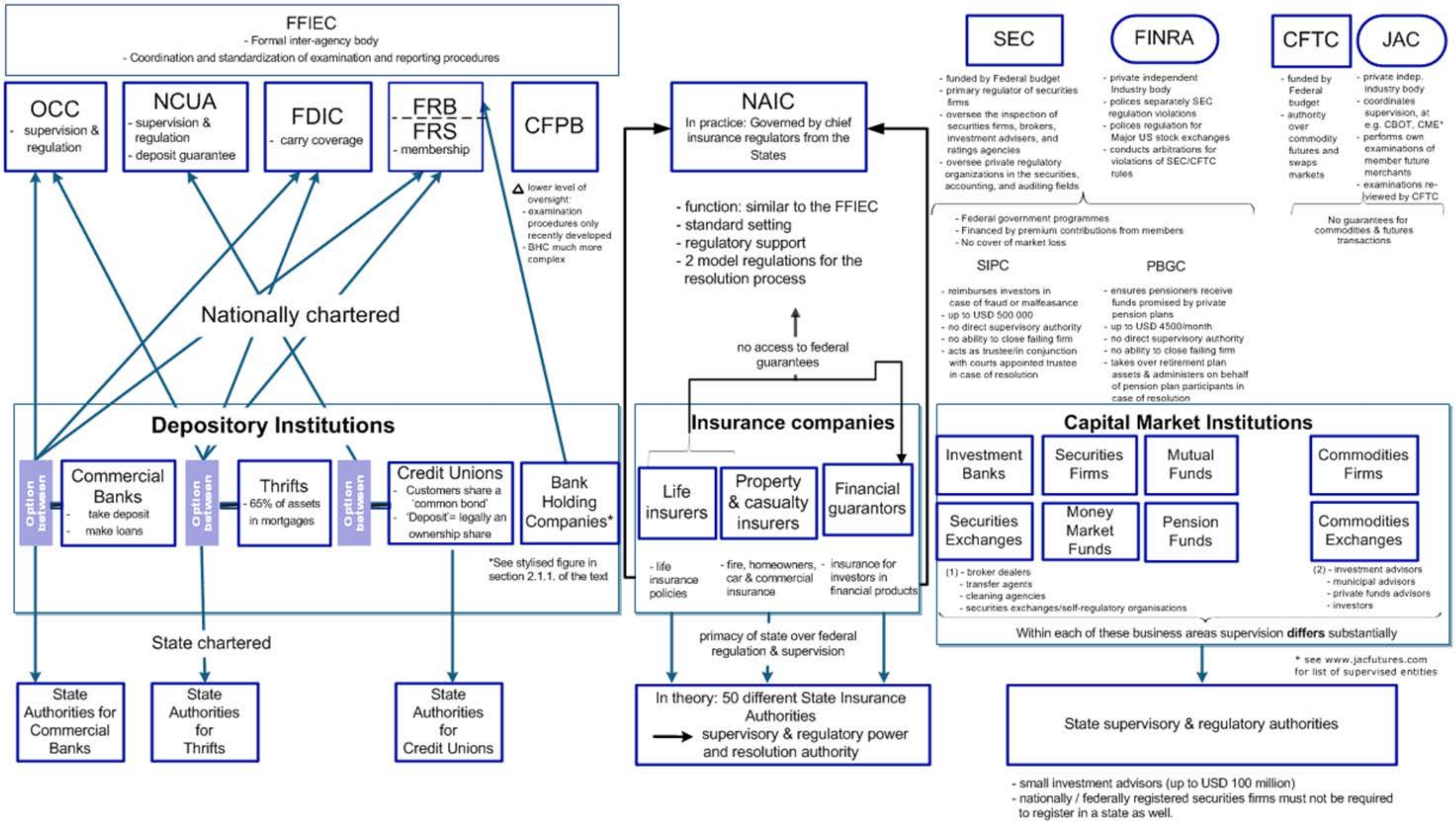


**Figure 12: Depository Institutions**

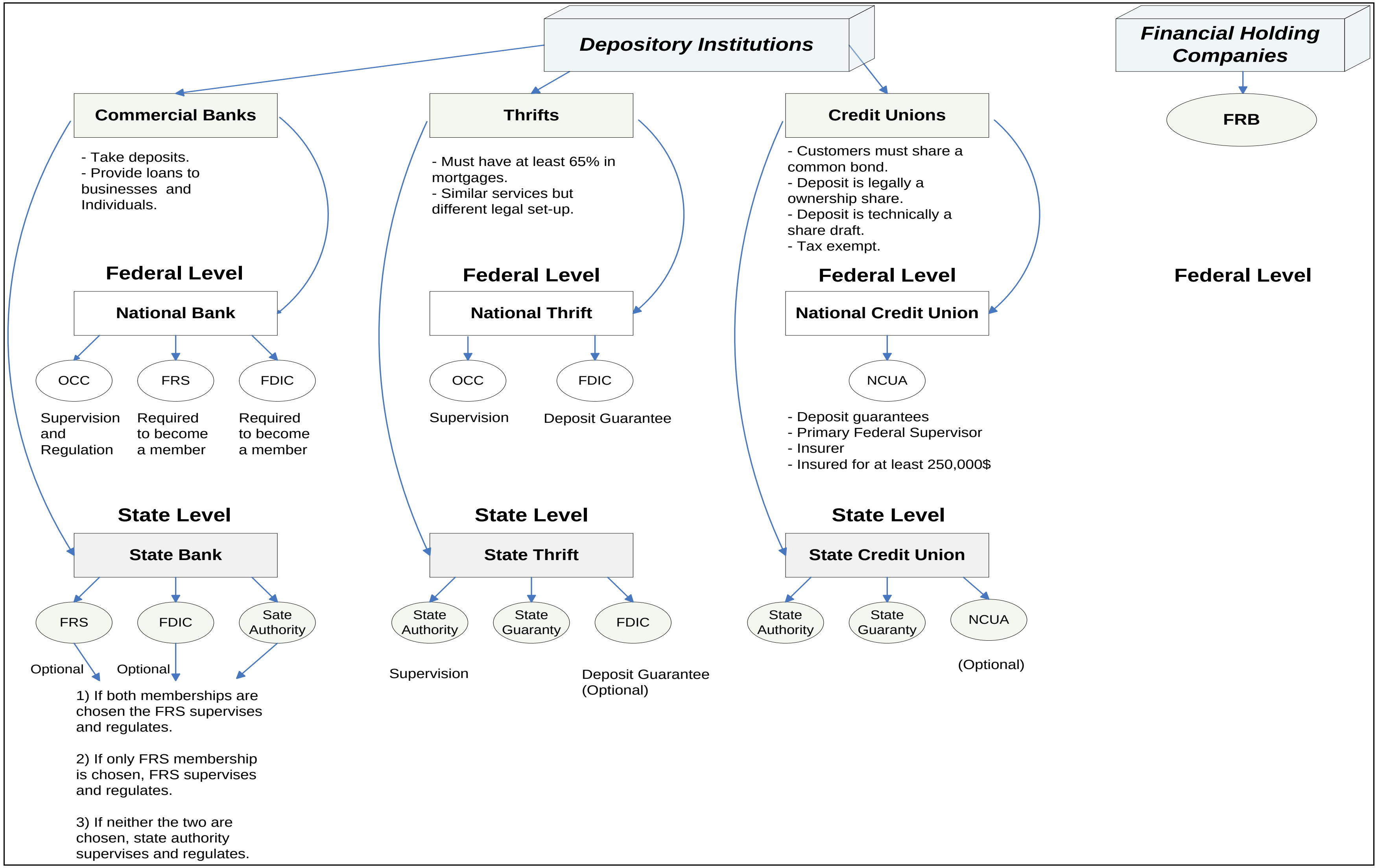


**Figure 13: The Federal Financial Institutions Examination Council (FFIEC)**

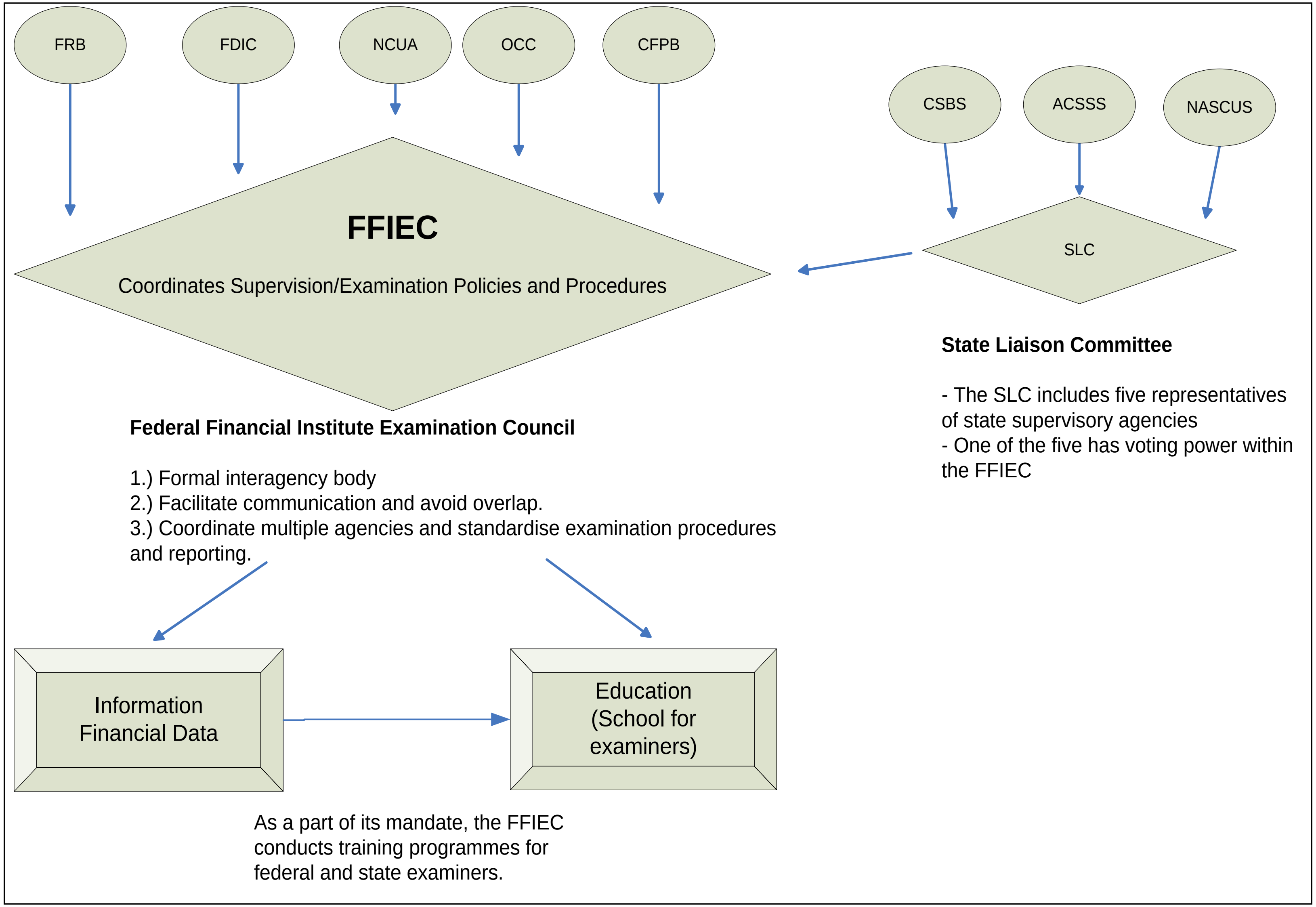


**Figure 14: Insurance Companies**

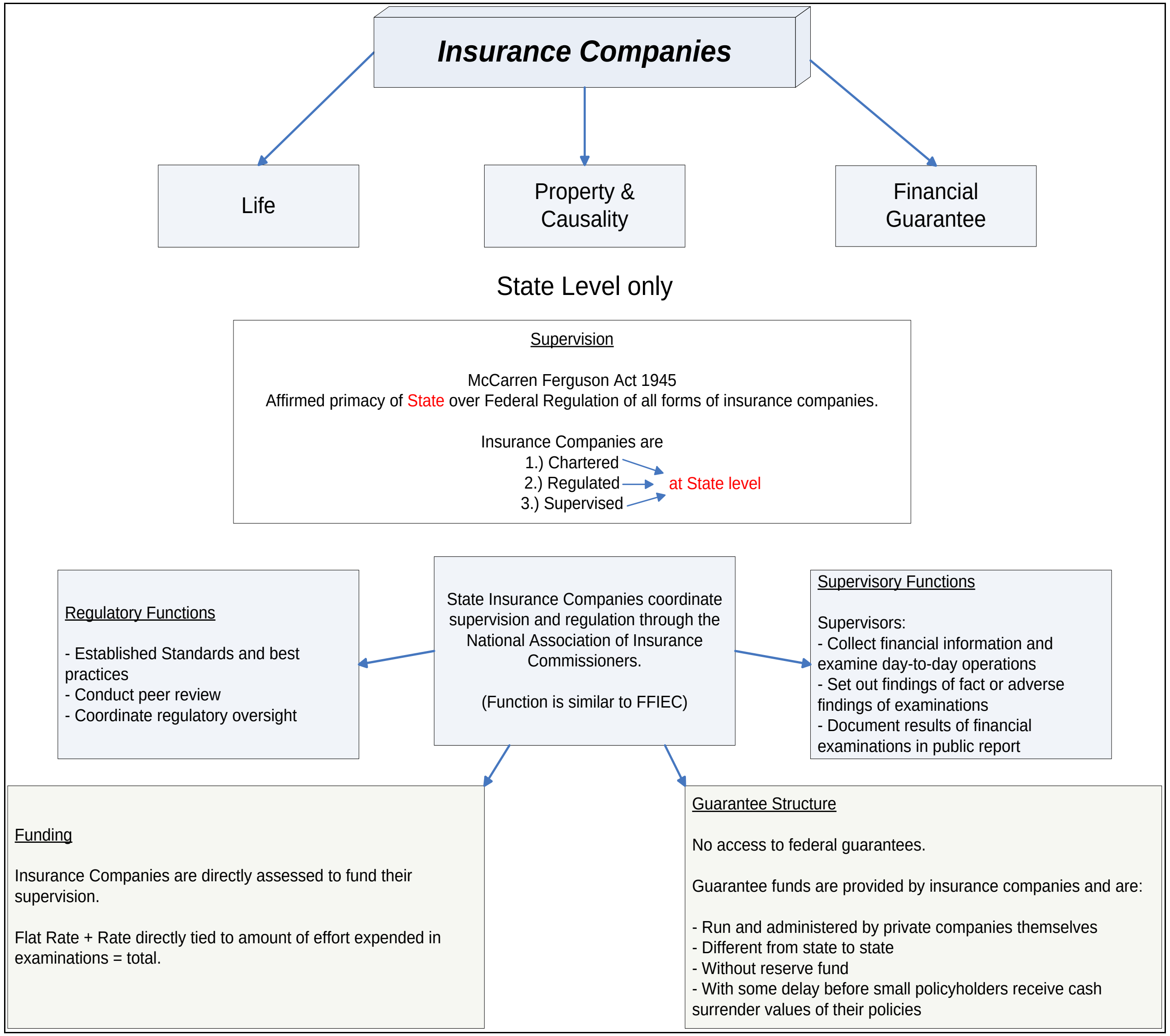
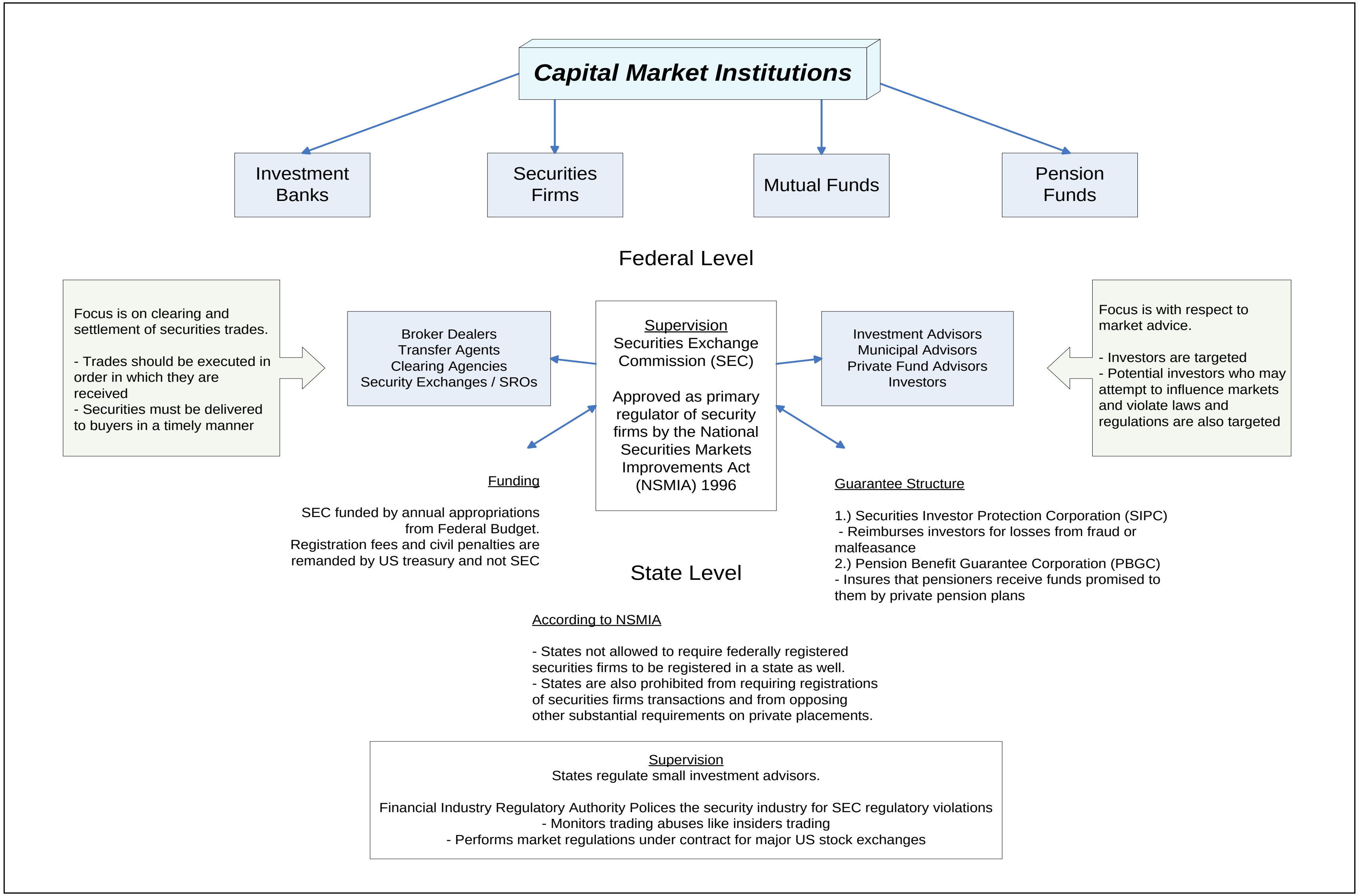


**Figure 15: Capital Market Institutions**



# NOTES

CAT: QA-02-15-659-EN-C (paper)
CAT: QA-02-15-659-EN-N (pdf)

DIRECTORATE-GENERAL FOR INTERNAL POLICIES

# POLICY DEPARTMENT A
# ECONOMIC AND SCIENTIFIC POLICY

## Role

Policy departments are research units that provide specialised advice to committees, inter-parliamentary delegations and other parliamentary bodies.

## Policy Areas

- Economic and Monetary Affairs
- Employment and Social Affairs
- Environment, Public Health and Food Safety
- Industry, Research and Energy
- Internal Market and Consumer Protection

## Documents

Visit the European Parliament website:
**http://www.europarl.europa.eu/supporting-analyses**

PHOTO CREDIT:
iStockphoto.com; Shutterstock/beboy


ISBN 978-92-823-7897-7 (paper)
ISBN 978-92-823-7896-0 (pdf)

doi: 10.2861/599104 (paper)
doi: 10.2861/45601 (pdf)

Publications Office

**Overview and Structure of Financial Supervision and Regulation in the US**