Devolution and Deregulation: The Paradox of Financial Reform

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In most areas of economic regulation, the movement toward greater state autonomy has been associated with deregulation both as a theoretical and as a political matter. In theory, devolution encourages deregulation by giving individual states discretion to relax the uniform rules typical of federal regulatory programs. Not surprisingly, state empowerment has found favor among politicians looking for ways to roll back intrusive federal economic regulation.

In the case of financial regulation, however, this convergence between devolution and deregulation has been absent. State empowerment frequently has resulted in increased regulatory burdens on financial institutions, requiring federal preemption to achieve deregulation. This Article will analyze several examples of this phenomenon, provide some possible reasons for the anomaly, and describe the dilemma that it has created for financial regulatory reform.

I. Regulatory Competition, Bank Chartering, and the Race to Deregulate

In financial regulation, the appeal of devolution is not new. Competition for regulatory authority between federal and state sovereigns has flavored the history of regulation of banks, insurance companies and even securities firms. Although questions of federalism were largely resolved decades ago in the areas of insurance and securities regulation—insurance regulation was left primarily to the states by virtue of the McCarran-Ferguson Act,[1] while securities regulation became primarily the responsibility of the federal Securities and Exchange Commission[2]—bank regulation is characterized by an

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1. McCarran-Ferguson Act, 15 U.S.C. §§ 1011-15 (1994). Adopted in 1945, McCarran-Ferguson was Congress's answer to the Supreme Court's ruling that insurance was interstate commerce in United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944). McCarran-Ferguson restored regulatory autonomy to the states except in cases of express federal preemption.

2. Created in 1934, the SEC administers six federal statutes governing the public issuance, transfer and trading of investment securities. *See* Securities Act of 1933, 15 U.S.C. § 77a to 77aa (1994); Securities Exchange Act of 1934, 15 U.S.C. § 78a to 78*ll* (1994); Public Utility Holding Company Act of 1935, 15 U.S.C. § 79a to 79z-6 (1994); Trust Indenture Act of 1935, 15 U.S.C. § 77aaa to 77bbbb (1994); Investment Company Act of 1940, 15 U.S.C. § 80a-1 to 80b-21 (1994); Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa to 78*lll* (1994); *see also* Private Securities Litigation Reform Act of 1995, P.L. 104-67, 109 Stat. 737-64 (amending Securities Act of 1933 and Securities Exchange

uneasy sharing of power among competing regulatory authorities. Banks may choose between a state and a national charter and, despite a significant overlay of federal regulation, the chartering authority remains responsible for determining the mix of available powers and privileges. Since bank chartering law specifies the businesses into which banking firms may diversify,[3] the menu of powers offered by different chartering authorities has a potentially significant effect on bank profitability.

Standard economic analysis of this "dual banking system" has borrowed from corporate law models of competition among the states for corporate charters, often referred to as the "race to the bottom"[4] (or, from another perspective, the "race to the top"[5]). The dual banking system is seen as creating an auction for bank charters that roughly mirrors the rivalry among states for corporate charters.[6] Interstate rivalry for bank charters is assumed to be minimal because banks cannot opt among state chartering authorities as costlessly as nonbank firms.[7] National chartering restores the option to choose between at least two competing chartering authorities offering different menus of bank powers.

This competitive model of bank chartering assumes that, first, banks can

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Act of 1934). Congress preserved the right of states to regulate securities transactions within their borders, *see* 15 U.S.C. § 77r (1994), but the national scope of most securities transactions ensures the primacy of the federal regulatory scheme.

3. *E.g.*, 12 U.S.C. § 24 (para. seventh) (1994) (limiting national banks to certain enumerated powers and "such incidental powers as shall be necessary to carry on the business of banking"); N.Y. BANKING LAW § 96 (McKinney 1990) (limiting powers of New York state-chartered banks to those expressly granted by New York banking law).

4. "Race to the bottom" theorists argue that the freedom of business entities to chose their state of incorporation without federal interference encourages competition among states for chartering revenues. To attract charters, states offer corporate managers business-friendly regulatory regimes, weakening legal restraints on managerial discretion. *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974) (finding that the decline of corporate standards largely stems from a move to the least common denominator).

5. "Race to the top" theorists accept the model of state charter competition but view the resulting regulatory equilibrium as efficient, producing in most cases the optimal set of legal rules governing corporate conduct. *See* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (finding state regulation to be superior to federal).

6. *See* Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1 (1977).

7. In the past, the main barrier to interstate competition for bank charters was state law prohibiting interstate branching, which required banks to locate their deposit-taking facilities within their chartering jurisdiction. Since relocation was costly, banks had no credible threat of exit that could be used to extract more favorable laws from their chartering state. In practice, however, banking firms that were dissatisfied with their chartering state did find an escape route: they could charter a new bank in a friendlier jurisdiction and transfer non-deposit operations and jobs to the new state, a tactic that was used by the banking industry in the late 1970s to bargain for favorable changes in state usury laws. *See* Robert A. Burgess & Monica A. Ciolfi, *Experimentation or Exploitation? A State Regulator's View of Interstate Credit Card Transactions*, 42 BUS. LAW. 929 (1987) (noting this trend in credit card solicitation). Moreover, now that interstate branching is becoming a reality (thanks to federal preemption, *see infra* Section II.B), banks should be able to shop for state charters almost as easily as nonbank firms.

shift between a national and state charter without prohibitive transaction costs[8] and, second, banks will shop for the menu of powers and privileges that maximizes firm value. Chartering authorities in turn are presumed to have incentives to make their laws more attractive in order to attract more charters.[9] Thus, competition between national and state chartering authorities should encourage regulatory experimentation. Since most banks will choose the set of rules that permits them the most flexibility in setting investment policy, the legal equilibrium that results from chartering competition should be deregulatory, as "race to the bottom/race to the top" theories would predict.[10]

A dissenting view of the dual banking system also begins with the corporate model of competition for charters, but concludes that competition for bank charters is weak or nonexistent due to the overlay of federal regulation.[11] Banks that choose a state charter become subject to federal regulation anyway if they join the Federal Reserve system or participate in federal deposit insurance,[12] now mandatory under the laws of many states.[13] Since the

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8. *See* Scott, *supra* note 6, at 9 (citing right to switch charters as key element of the dual banking system).

9. Charters produce rents in the form of chartering fees and related revenues; therefore, chartering authorities have incentives to vie for market share. The competitive model of bank chartering assumes that the national chartering authority (the Office of the Comptroller of the Currency, part of the Treasury Department) has the same incentives as the states to maximize charter revenues, or at least will respond to charter losses by making the national chartering option more attractive. *See* Scott, *supra* note 6, at 33. As Section III.A will discuss, the Comptroller's office has a stake in attracting or retaining bank charters; lost charters (and lost charter fees) mean smaller budgets and fewer employees. *See also* Justin Fox, *In Blow to OCC, N.Y. Megabank Decides to Go With a State Charter*, AM. BANKER, Aug. 31, 1995, at 1 (describing financial impact of significant charter defections on Comptroller's budget and staff). Recent anecdotal evidence confirms that the national chartering authority will behave like a classic rent-seeker when competing with the states for bank charters. *See, e.g.*, Justin Fox, *Stampede Toward State Charters Makes the OCC Change Its Tune*, AM. BANKER, Aug. 28, 1995, at 3 (describing efforts by the Comptroller to halt charter defections by making national bank regulation more "user friendly").

10. Deregulation has not always been the outcome of the competition for corporate charters, as "race to the top" adherents have recognized. *See* William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1881 (1995) (citing state antitakeover legislation as an example of charter market failure). Moreover, since financial regulation performs a signalling function and reassures cautious investors and customers as to the safety of financial institutions, the optimal regulatory equilibrium may never be zero regulation. Nevertheless, most proponents of the competitive story assume that banks remain overregulated rather than underregulated, leaving room for competition by deregulation. *See* Scott, *supra* note 6, at 36 (predicting that regulatory competition will lead to legal regime that offers banks broader operating authority and lowered constraints on profitability).

11. *E.g.*, Geoffrey P. Miller, *The Future of the Dual Banking System*, 53 BROOKLYN L. REV. 1 (1987); Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677 (1988) (arguing federal preemption and uniformity are stronger than competitive forces).

12. Participation in these federal programs subjects banks to different federal regulators: the Federal Reserve supervises state-chartered banks that join the Federal Reserve system (member banks), while the Federal Deposit Insurance Corporation supervises state-chartered insured nonmember banks. For a description of this division of regulatory authority and its implications for the regulatory competition story, *see* Scott, *supra* note 6, at 5-8.

13. For examples *see infra* note 72.

federal government, unlike the states, bears much of the cost of bank failure,[14] federal regulators are more interested in preserving bank safety and soundness than in making their regulation more banker friendly.[15] The result will be overly restrictive federal regulation that preempts state experimentation with broader bank powers.

Although these two views of the dual banking system differ as to the degree of regulatory competition that can be expected, they concur that the likely effect of greater devolution is greater deregulation. Both approaches assume that states will be responsive to banks' demand for greater investment opportunities so long as they have a real opportunity to compete for charters free from national interference. Therefore, enhancing state authority over banks should encourage deregulation.

II. Devolution, Reregulation, and the Demand for Preemption

Although the competitive story would predict that increasing state autonomy should improve regulatory competition, leading the way to deregulation, to the extent that devolution has taken place in bank regulation, the result has been the opposite. On balance, state regulation has proved more restrictive than federal regulation, requiring federal preemption to force deregulation. There have been exceptions: states such as South Dakota and Delaware have adopted explicitly deregulatory policies in order to attract bank charters,[16] while Congress occasionally has preempted state experimentation.[17] Nevertheless, the trend has been the other way, and never so clearly as in the mid-1990s as devolution and deregulation have become important priorities for both Congress and the Clinton administration. This essay will look at four examples of this anomaly.

A. *Bank Powers*

Initially, a bank's menu of powers is determined by its chartering authority. Federal regulatory authorities such as the Federal Reserve and the Federal Deposit Insurance Corporation may further limit bank powers by restricting the investments and activities of their member banks in order to protect the safety

14. This is the consequence of federal deposit insurance and the federal banking agencies' prominent role in administering failing banks. *See, e.g.*, 12 U.S.C. § 347b (1994) (giving Federal Reserve authority to make liquidity loans to troubled banks).

15. Both the Federal Reserve and the FDIC collect fees for services from their members and therefore have at least some incentive to compete for banks by making membership more attractive. Moreover, each agency's stable of banks constitutes a powerful constituency that may help enhance the agency's reputation and clout in Congress, leading to favorable funding outcomes. These factors suggest that federal regulators may not act monolithically and that some interagency competition for banks may take place at the federal level.

16. *See infra* Section III.B.

17. *See infra* note 19.

and soundness of the banking system. In addition, Congress occasionally has acted to bar specific conduct by banks. The most famous examples are the 1933 Glass-Steagall Act,[18] which limited bank participation in the securities business, and Title VI of the Garn-St Germain Depository Institutions Act of 1982,[19] which barred affiliates of banks from most aspects of the insurance business.

Compared to laws governing nonbanking firms, laws governing bank diversification historically have been restrictive regardless of their source. Most banks have been limited to the traditional banking business and related activities determined to be incidental to the business of banking.[20] Banks have been excluded not only from obviously "nonbanking" activities such as oil exploration[21] but also from financial businesses such as securities underwriting[22] and insurance.[23]

Recent competitive pressure from rival financial firms and foreign banks has made diversification a priority for the banking industry. The industry's principal concern has been its inability to expand into other financial businesses. In recent years, national policy makers have become increasingly sympathetic to bankers' desire to diversify. In 1991, for example, the Treasury Department proposed a comprehensive restructuring of federal financial regulation to permit affiliations between banks, securities firms, and insurance

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18. 12 U.S.C. §§ 24 (para. seventh), 78, 377, 378 (1994). Although some prohibitions apply only to Federal Reserve member banks, Glass-Steagall's ban on deposit-taking by firms engaged in the business of corporate securities underwriting (Section 21) affects all banks regardless of charter or Federal Reserve membership, 12 U.S.C. § 378 (1994).

19. 12 U.S.C. § 1843(c)(8) (1994). Garn-St Germain amended the Bank Holding Company Act, which empowers the Federal Reserve Board to specify the menu of powers available to bank holding companies and their nonbank subsidiaries, to stop the Board from allowing bank affiliates to sell insurance other than credit-related insurance, thereby avoiding a conflict with state laws barring affiliations between banks and insurance firms. The permissibility of insurance sales by banks themselves presents a different legal issue; generally, the laws of the relevant chartering authority govern. *See* Independent Ins. Agents of Am. v. Board of Governors of the Fed. Reserve Sys., 890 F.2d 1275 (2d Cir. 1989). *But see infra* text accompanying notes 36-38 (describing states' attempts to regulate national bank insurance sales within their jurisdictions).

20. Traditional activities include discounting and negotiating promissory notes, drafts, and bills of exchange; receiving deposits; buying and selling exchange, coin, or bullion; lending money; and obtaining, issuing, and circulating notes. 12 U.S.C. § 24 (para. seventh) (1994). *See also* United States v. Philadelphia Nat. Bank, 374 U.S. 321, 326-27 n.5 (1963) (describing mix of related services and credit devices that comprise traditional banking business, including secured and unsecured loans, installment financing, credit cards, deposits, estate planning and trusteeship, safety deposit boxes, foreign acceptances and letters of credit, correspondent services, and investment advice).

21. *E.g.*, Wilshire Oil Co. v. Board of Governors of the Fed. Reserve Sys., 668 F.2d 732 (3d Cir. 1982).

22. *See supra* note 18.

23. *See supra* note 19. There is an enormous body of literature, much of it critical, that seeks to describe and explain the history of U.S. bank asset regulation, which is significantly more restrictive than the banking laws of other jurisdictions, especially Germany. For two assessments of the U.S. approach from differing perspectives, see Helen A. Garten, *Subtle Hazards, Financial Risks, and Diversified Banks: An Essay on the Perils of Regulatory Reform*, 49 MD. L. REV. 314 (1990); Stephen K. Halpert, *The Separation of Banking and Commerce Reconsidered*, 13 J. CORP. L. 481 (1988).

companies.[24]

Although the Treasury's scheme fell victim to pressure on Congress to resolve the thrift crisis,[25] by the mid-1990s conditions appeared more favorable for federal banking reform, particularly repeal of the Glass-Steagall Act. First, Republican gains in the 1994 mid-term congressional elections meant that the new Chairman of the House Banking Committee was Representative Jim Leach of Iowa, a respected banking expert who was committed to Glass-Steagall reform.[26] Second, Glass-Steagall reform was a bipartisan issue;[27] even the Clinton administration had endorsed reform in principle.[28] Finally, Representative Leach's proposed legislation,[29] which expanded bank securities powers without making radical changes in the federal regulatory structure,[30] had the support of the Federal Reserve and key players in both the banking and securities industries.[31] When the *American Banker*, a leading trade journal of the financial industry, asked, "Will 1995 be the year that the Glass-Steagall Act finally tumbles?"[32] many observers were cautiously optimistic.

At the same time, federal bank regulators were responding to bankers' demand for greater powers. The Comptroller of the Currency, the Treasury Department official charged with overseeing national banks, was interpreting national banking laws to enlarge the menu of powers available to national banks, especially insurance-related powers. In 1990, the Comptroller's office concluded that the sale of annuities by national banks was incidental to the business of banking and did not constitute a prohibited insurance activity, an interpretation upheld by the Supreme Court.[33] The Comptroller also read 12

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24. *See* U.S. Department of Treasury, Modernizing the Financial System: U.S. Treasury Department Recommendations for Safer, More Competitive Banks, Fed. Banking L. Rep. (CCH) (Feb. 14, 1991).

25. The FDIC Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236, contained none of the Treasury's structural reforms and focused primarily on improving bank capital levels and strengthening regulatory authority over troubled banks.

26. *See* Suzanna Andrews, *Banking on Jim Leach*, INSTITUTIONAL INVESTOR, June 1995, at 11.

27. *See* Martha M. Canan, *Battle Over Banks' Role in Securities Is a Clash of Viewpoints, Not of Parties*, BOND BUYER, Oct. 17, 1994, at 3.

28. *See* Ron Scherer, *Clinton Proposes a Brave New Banking World*, CHRISTIAN SCI. MONITOR ONE, Mar. 1, 1995, at 1.

29. Financial Services Competitiveness Act of 1995, H.R. 1062, 104th Cong., 1st Sess. (1995).

30. H.R. 1062 required most new securities activities to be conducted through bank holding company affiliates separated by firewalls from deposit-taking operations and regulated by the Federal Reserve. This organizational structure had already been used by the Federal Reserve to permit limited entry by bank holding companies into the underwriting business. *Cf.* J.P. Morgan & Co. et al., 75 FED. RESERVE BULL. 192 (1989) (Federal Reserve decision allowing banks to engage in limited amounts of securities underwriting through separately incorporated affiliates).

31. *Banks, Securities Companies Exploring Links; Legislation: Administration and Congress Are Looking Into Easing or Repealing 60-Year-Old Restrictions*, L.A. TIMES, Mar. 14, 1995, at 10.

32. Robert Garsson, *Glass-Steagall Won't Go Quietly, So Expect Reform But Not Outright Repeal*, AM. BANKER, Oct. 21, 1994, at 3.

33. Nationsbank of North Carolina v. Variable Annuity Life Ins. Co., 115 S. Ct. 810 (1995).

U.S.C. § 92 of the national banking laws,[34] a 1916 provision that authorized national banks located in small towns to act as insurance agents, to allow those banks to market insurance products to customers nationwide.[35]

Thus, by the mid-1990s, a movement toward expansion of bank powers was underway at the national level. Ironically, however, the principal barrier to accomplishing deregulation was the concurrent movement in Congress to return regulatory authority to the states. While the national sovereign was broadening the menu of powers available to national banks, many states had moved in the opposite direction, creating legal barriers between banking and insurance.[36] These state laws were in direct conflict with the national chartering authority's attempts to expand bank powers and ran counter to the national trend to deregulate bank activities.

Not all states chose to impose more restrictions on banks than the national sovereign. Some, notably California, South Dakota, and Delaware, moved to expand bank powers to allow entry into the insurance business.[37] Nevertheless, in 1995 one third of the states, including all six New England states, New Jersey, Pennsylvania, Texas, and Florida, placed greater limits on bank insurance activities than those governing national banks.[38]

These restrictive state laws had two effects on efforts at the national level

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34. For the pertinent portion of 12 U.S.C. § 92 (1988), *see infra* note 41.

35. *See* NBD Bank v. Bennett, 67 F.3d 629 (7th Cir. 1995); Independent Ins. Agents v. Ludwig, 997 F.2d 958 (D.C. Cir. 1993) (upholding Comptroller's interpretation of 12 U.S.C. § 92).

36. Many of these state laws predated the most recent movement by the national sovereign to expand bank insurance powers; for example, Florida's prohibition on affiliations between banks and insurance agents was enacted in 1974. *See* FLA. STAT. ANN. § 626.988 (West 1984 & Supp. 1996). Florida's statute was adopted in response to an earlier movement at the national level, this time initiated by the Federal Reserve, to expand the powers of bank holding companies to enter the insurance business. *See* Florida Ass'n of Ins. Agents v. Board of Governors of the Fed. Reserve Sys., 591 F.2d 334 (5th Cir. 1979). The states eventually won this battle when Congress amended the Bank Holding Company Act to prevent the Federal Reserve from approving new insurance powers for bank holding companies, *see supra* note 19. When the Comptroller of the Currency's policies posed a new threat to state insurance regulation in the 1990s, some states saw the need to reaffirm their opposition to bank insurance activities. *See, e.g.*, LA. REV. STAT. ANN. § 6:121B(2) (West 1986 & Supp. 1996) (restrictions on bank insurance activities reenacted and strengthened); Ky. House Res. 91-55-BR-63 (Jan. 31, 1991) (restrictions on bank insurance activities reaffirmed).

37. In 1988, California voters approved Proposition 103, which repealed prohibitions on bank entry into the insurance business. *See* CalFarm Insurance Co. v. Deukmejian, 48 Cal. App. 3d 805 (1989) (upholding constitutionality of portions of Proposition 103); *see also* S.D. CODIFIED LAWS § 51A-4-4 (1990) (allowing state chartered banks to engage full insurance activities); DEL. CODE ANN. tit. 5, § 761(a)(14) (1993) (same with the exception of title insurance).

38. *See, e.g.*, CONN. GEN. STAT. ANN. § 38a-755 (West 1992 & Supp. 1994); FLA. STAT. ANN. § 626.988 (West 1984 & Supp. 1996); KY. REV. STAT. ANN. § 287.030(4) (Michie/Bobbs-Merrill 1988); LA. REV. STAT. ANN. § 6:121B(2) (West 1986 & Supp. 1996); ME. REV. STAT. ANN. tit. 24-A, § 1514-A(2) (West 1990 & Supp. 1995); MASS. GEN. LAWS ANN. ch. 175, § 174E (West 1987 & Supp. 1995); NEV. REV. STAT. ANN. § 683A.110 (Michie 1992 & Supp. 1995); N.H. REV. STAT. ANN. § 384:16-b(II) (1983); N.J. STAT. ANN. § 17:3C-1 (West 1984); OKLA. STAT. ANN. tit. 36, § 1424-(B)(6) (West 1990 & Supp. 1994); PA. STAT. ANN. tit. 40, § 281(b) (1992); R.I. GEN. LAWS §§ 27-3-46 to 47 (1994); TENN. CODE ANN. § 56-6-201(a) (1994); TEX. INS. CODE ANN. art. 21.07-3 5(h) (West 1991); VT. STAT. ANN. tit. 8, § 4811(a) (1993); W. VA. CODE §§ 31A-8C-1, 31A-8C-2(f) (Supp. 1994).

to achieve financial deregulation. First, they created a legal conflict as state and national sovereigns vied for primary authority to control bank entry into the insurance business. Second, they ignited a political conflict that threatened to derail efforts to achieve broader financial deregulation at the federal level.

1. *The Legal Conflict*

The divergent positions taken by national and many state sovereigns over the permissibility of bank insurance activities reopened questions of federalism that seemingly were resolved decades ago. Relying on the McCarran-Ferguson Act,[39] which restored autonomy to the states over the regulation of insurance, states claimed the power to bar all banks, whether state or nationally chartered, from engaging in the insurance business within their borders.[40] This would permit individual states to block efforts by the Comptroller of the Currency to attract charters by offering national banks broader insurance powers than those available under state law. Put another way, devolution would trump regulatory competition.

This conflict emerged in the mid-1990s when national banks, in reliance on the Comptroller's interpretation of 12 U.S.C. § 92, proposed to use small town branches as vehicles to sell insurance. Section 92 permits national banks with offices in small towns (defined as towns with 5,000 or fewer inhabitants) to act as insurance agents.[41] The Comptroller ruled that national banks could use their small town branches as a base to sell insurance to customers anywhere, an interpretation of section 92 that as of 1995 had been upheld by the two appellate courts that had considered the question.[42]

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39. 15 U.S.C. § 1012 (1994).

40. The state statutes cited in note 38, *supra*, barred affiliations between an insurance agent licensed to conduct an in-state insurance business and any banking organization regardless of charter. State legislatures claimed to derive legal authority to regulate the activities and affiliations of banks chartered by the national sovereign from state power to set the qualifications of licensed insurance agents; in exercising this power to prevent banks from affiliating with insurance agents, state legislatures cited the need to protect consumers from coercive tying arrangements (when borrowers are forced to buy insurance as a condition to obtaining bank credit), conflicts of interest, and other unfair trade practices. For example, Florida's antiaffiliation statute, FLA. STAT. ANN. § 626.988 (West 1984 & Supp. 1996), appeared in the state's Unfair Trade Practices Act, the purpose of which, according to the legislature, was to "regulate trade practices relating to the business of insurance in accordance with [the McCarran-Ferguson Act] by defining . . . all such practices in this state which constitute unfair methods of competition or unfair or deceptive acts or practices and by prohibiting the trade practices so defined or determined." FLA. STAT. ANN. § 626.951 (West 1984 & Supp. 1996).

41. The section reads in pertinent part:

> [A]ny [national bank] association located and doing business in any place the population of which does not exceed five thousand habitants, . . . 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 in which said bank is located to do business in said State, by soliciting and selling insurance and collecting premiums on policies issued by such company . . . .

12 U.S.C. § 92 (1994).

42. *See supra* note 35 and sources cited therein.

In response, insurance officials in several states moved to block national banks from selling insurance under local laws barring banks or their affiliates from acting as insurance agents.[43] Insurance officials argued that the McCarran-Ferguson Act immunized state laws regulating the business of insurance from federal preemption.[44] Since McCarran-Ferguson exempts acts of Congress that specifically relate to the business of insurance, however, national banks argued that 12 U.S.C. § 92 preempted state insurance laws.[45]

The Supreme Court ultimately resolved this conflict between McCarran-Ferguson and the national banking laws in favor of the national banks.[46] As a result, national banks will be free to act as insurance agents through their small town branches, but the clash between chartering authorities is likely to continue. States may still claim the power to bar national banks from other aspects of the insurance business, such as insurance underwriting, that are not specifically authorized by federal statute. The Comptroller may still try to facilitate national bank entry into all facets of the insurance business by classifying those activities as among the incidental powers of national banks.[47]

Thus, because of a congressional decision to cede regulatory power over insurance to the states, full bank entry into the insurance business may be achieved only through one of three legal routes. First, the Comptroller of the Currency and national banks may continue to wage costly piecemeal legal battles over the reach of restrictive state law, counting on the federal courts to limit state autonomy. Second, states may be persuaded to follow the lead of the Comptroller and dismantle barriers to bank entry into the insurance business. Finally, Congress may adopt preemptive legislation returning regulatory authority over insurance to the national sovereign, freeing the Comptroller to

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43. *See* Barnett Bank of Marion County, N.A. v. Gallagher, 43 F.3d 631 (11th Cir. 1995) *rev. sub nom.* Barnett Bank of Marion County, N.A. v. Nelson, Sup. Ct. Docket No. 94-1837 (decided Mar. 26, 1996); Owensboro Nat'l Bank v. Stephens, 44 F.3d 388 (6th Cir. 1994); First Advantage Ins. v. Green, 652 So. 2d 562 (La. Ct. App., 1st Cir. 1995), *cert. denied*, 654 So. 2d 331 (La. 1995).

44. *See* Barnett Bank of Marion County, N.A. v. Nelson, Sup. Ct. Docket No. 94-1837 (Brief for Respondents Bill Nelson and the Florida Department of Insurance); *see also supra* note 40.

45. The relevant portion of McCarran-Ferguson states that, "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, . . . unless such Act specifically relates to the business of insurance." 15 U.S.C. § 1012(b) (1994).

46. Barnett Bank of Marion County, N.A. v. Nelson, Sup. Ct. Docket No. 94-1837 (decided Mar. 26, 1996) (holding that section 92 "specifically relates to the business of insurance" within the meaning of McCarran-Ferguson). Although the Court did not directly address the power of states to place conditions on national banks functioning as insurance agents (such as state licensing requirements), the Court's reading of section 92 suggests that states may not apply local regulations that would significantly interfere with national banks' exercise of insurance agency powers.

47. *Cf. NationsBank*, 115 S. Ct. 810 (upholding Comptroller's ruling that sale of annuities falls within the incidental powers of national banks). The Comptroller's assault on restrictive state regulation is not limited to insurance. In 1995, the national sovereign authorized national banks to ignore state laws requiring bank trust departments to maintain in-state headquarters, thereby challenging state autonomy over local trust business. *See* Olaf de Senerpont Domis, *OCC Ruling Lets Bank Trust Units Go Interstate*, AM. BANKER, Dec. 26, 1995, at 1.

continue to expand national bank powers.

2. *The Political Conflict*

While national banks counted on the federal courts to limit the reach of restrictive state law, supporters of bank insurance restrictions looked to Congress to reaffirm state autonomy by curbing the authority of the Comptroller of the Currency to grant broader powers to banks than were allowed by state law. In this effort, they had the support of congressional architects of devolution who were philosophically opposed to any expansion of federal regulatory power, even when the national sovereign was using its power to deregulate banks.

In 1995, proponents of devolution halted the progress of two popular deregulatory initiatives that had nothing to do with bank insurance powers: the long-awaited Glass-Steagall reform bill[48] and a regulatory relief bill.[49] Defenders of state autonomy (who included important members of the House leadership) insisted that any banking reform legislation include a moratorium on the Comptroller of the Currency's authority to grant national banks new insurance powers.[50] In response, many banks withdrew their support for the reform bills despite the promise of new securities powers.[51] The Comptroller of the Currency called upon national banks to defeat the legislation.[52]

The turf wars between the banking and insurance industries that sparked these legal and political battles are certainly nothing new. Banks want to enter the insurance business; insurance agents want to keep banks out. Both are likely to try to achieve their goals by influencing legislative outcomes.[53] What is new is the emerging philosophical conflict between the ideals of deregulation and devolution as applied to financial regulation. Devolution promised to

48. Financial Services Competitiveness Act of 1995, H.R. 1062, 104th Cong., 1st Sess. (1995).

49. Financial Institutions Regulatory Relief Act of 1995, H.R. 1858, 104th Cong., 1st Sess. (1995). Both bills were reintroduced as a single package in H.R. 2520, 104th Cong., 2d Sess. (1995).

50. Supporters of the moratorium included House Rules Committee Chairman Gerald Solomon (R-NY), Commerce Committee Chairman Thomas Bliley (R-VA), and the Commerce Committee's ranking minority member John Dingell (D-MI). Since these committees could prevent financial legislation from reaching the floor of the House, Banking Committee Chairman Jim Leach had to take their concerns seriously. In September 1995, in a compromise worked out between Speaker Newt Gingrich and the three committee chairman, Leach agreed to include the moratorium in his banking reform package and to drop an amendment sponsored by Representative Richard Baker that would have preempted all state antiaffiliation laws and permitted bank-insurance links. *See* Olaf de Senerpont Domis, *Regulatory Relief Bill Advancing, At a Price*, AM. BANKER, Sept. 13, 1995, at 1.

51. Bill McConnell, *36 CEOs Urge Gingrich to Kill Insurance Curbs*, AM. BANKER, Oct. 13, 1995, at 1.

52. Jaret Seiberg, *Comptroller To Bankers: Insurance Sales Crucial*, AM. BANKER, Oct. 10, 1995, at 1. The Comptroller had independent reasons to object to the Glass-Steagall reform bill considered by Congress in 1995. H.R. 1062 required securities activities to be conducted through bank holding company affiliates, see *supra* note 30. Under the current division of federal regulatory authority, bank holding company affiliates are supervised by the Federal Reserve, not the Comptroller.

53. *See infra* Section III.C for a more complete description of this bargaining process.

accelerate the deregulatory process by freeing states to experiment. Yet true financial deregulation may require extensive federal preemption that will impose the kinds of uniform national standards that prevent state experimentation.

This result is at odds with the standard story of regulatory competition in either its strong or its weak form. The strong version suggests that competition among national and state chartering authorities should produce an equilibrium that will be at least somewhat deregulatory. Theoretically, if the national sovereign expands bank insurance powers in order to attract bank charters, the states must follow suit in order to retain bank charters. Rather than producing an equilibrium, however, regulatory competition appears to be encouraging wide variations in regulatory approach as the national and some state sovereigns pursue diverging and occasionally conflicting policies. Equilibrium can be achieved only by federal preemption that puts an end to regulatory competition.[54]

This result is equally inconsistent with the weak version of the competitive story, which assumes that meaningful competition for bank charters is stifled by federal regulation that is more concerned with protecting bank safety than with attracting bank charters. To the contrary, regulatory competition between state and national sovereigns appears to be taking place, but the national sovereign has been more responsive than many states to banks' demand for regulatory flexibility. Increasing state autonomy will preserve regulatory barriers between banking and insurance, while broad federal preemption may free banks to diversify.

B. *Interstate Banking*

Historically, geographical expansion by both national and state-chartered banks was under state control. States had the power to determine where and when their banks could establish branches. National banks were subject to the branching laws of the state in which their principal operations were located.[55] Neither national banks nor state member banks could open branches outside of

54. Alternatively, federal preemption may be necessary to force the states to participate in the kind of regulatory competition that the competitive story predicts. Many states do not want to mix banking with insurance, but if they cannot prevent national banks from selling insurance within their borders, they at least want to extend the same benefits to state-chartered banks. Under state "wild card" statutes, once the courts rule definitively that national banks may sell a particular product, such as annuities, state-chartered banks automatically enjoy the same privileges. *See, e.g.*, FLA. STAT. ANN. § 655.061 (West 1984 & Supp. 1996); *see also* Jaret Seiberg, *Docket: Fla. Ruling May Hold Key to Insurance Power*, AM. BANKER, Aug. 30, 1995, at 3. The result is a form of regulatory equilibrium, but it is hardly the outcome of free charter competition. States deregulate reluctantly, and only to the extent that they are precluded by preemption from applying their restrictive laws to national banks.

55. 12 U.S.C. § 36(c) (1994).

their home states.[56] States were even given the authority to prevent acquisitions of banks in their jurisdictions by out-of-state bank holding companies.[57] As a result, interstate banking was restricted despite innovations such as automatic deposit, banking by mail, and automated teller machines that increased the mobility of the deposit business.[58]

The longevity of interstate branching restrictions reflected the political skill of generations of advocates of devolution. Between 1924[59] and 1993, Congress repeatedly considered but rejected proposed legislation that would have permitted nationwide branching by national banks free from state interference.[60] The congressional decision to defer to state branching law allowed local jurisdictions to block the growth of nationwide banking operations, thereby protecting small local banks from competition.[61]

Recently, however, the national sovereign has actively intervened to dismantle state barriers to geographical diversification. The Comptroller of the Currency began the process by encouraging national banks to use an obscure provision of the national banking laws to relocate their main offices across state lines.[62] In 1994, Congress finally passed legislation preempting most state

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56. *Id.* Theoretically, states could allow nonmember banks to open interstate branches, but few did —at least until federal preemption made interstate banking inevitable. *See* Arthur E. Wilmarth, *Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks*, 77 IOWA L. REV. 957, 963 n.16 (1992); *see infra* note 63 and accompanying text.

57. 12 U.S.C. § 1842(d) (1988). In 1994, Pub. L. 103-328 amended § 1842(d) to authorize the Board to approve acquisitions of banks located in a State other than the home state of the acquiring bank, regardless of state laws, if the acquiring bank is adequately capitalized and managed. 12 U.S.C. § 1842(d) (1994).

58. In some cases, the legality of these innovations depended on legal findings that they did not constitute actual bank branches. *See, e.g.*, Independent Bankers Ass'n of N.Y. State v. Marine Midland Bank, 757 F.2d 453 (1985).

59. Congress was forced to address the interstate banking issue in 1924 because the Supreme Court had ruled that national banks had no clear statutory authority to establish branches when state laws prohibit branch banks. *See* First National Bank in St. Louis v. Missouri, 263 U.S. 640 (1924).

60. The McFadden Act of 1927, 44 Stat. 1228 (codified as amended at 12 U.S.C. § 36 (1994)), empowered national banks to establish branches in the municipalities in which their main office was located so long as state law gave similar branching authority to state-chartered banks. The Banking Act of 1933, 48 Stat. 189 (codified as amended at 12 U.S.C. 36 (c)(2) (1994)), empowered national banks to branch anywhere within their home state, but, again, only if state law gave similar branching privileges to state-chartered banks. Although Congress's intent appears to have been to achieve competitive equality between state and national banks, *see* First National Bank v. Walker Bank & Trust Co., 385 U.S. 252, 261 (1966), the legislative history suggests a different explanation: large national banks, national bank regulators, and other supporters of a national banking system were repeatedly frustrated in their effort to achieve unrestricted branching powers for national banks by a powerful political coalition of small unit banks, local businesses, and congressional supporters of state autonomy. See Wilmarth, *supra* note 56, at 972-75.

61. *See, e.g.*, 75 CONG. REC. S. 9892 (May 10, 1932) (statement of Senator Carter Glass (D-VA)). Glass, a strong advocate of interstate banking, accused his opponents of attempting to protect local monopolies over credit from competition from new bank entrants.

62. *E.g.*, Decision of the Office of the Comptroller of the Currency on the Applications of First Fidelity Bank, N.A., Pennsylvania, Philadelphia, Pa., and First Fidelity Bank, N.A., New Jersey, Newark, N.J., [1993-94 Transfer Binder] Fed. Banking L. Rep. (CCH) 89,644 (Jan. 10, 1994) (UCC Corp. Decision No. 94-04). 12 U.S.C. § 30(b) authorized national banks to relocate their main office to any authorized bank location within up to 30 miles beyond the limits of the city, town, or village in

barriers to interstate bank acquisitions and mergers.[63] States may opt out of interstate banking, but they may prevent interstate mergers only by adopting new legislation before June 1, 1997.[64]

The principal significance of the 1994 legislation is the extent to which it represents a shift in regulatory autonomy away from the states. As a substantive matter, preemption of state anti-acquisition rules did not radically alter the face of banking in the United States; during the 1980s, state law became much more permissive on the subject of geographical diversification and most states already allowed at least some interstate acquisitions. Nevertheless, congressional deference to state autonomy had encouraged states to experiment, and occasionally experimentation had led to overtly protectionist policies. For example, the first states to authorize interstate acquisitions adopted regional entry statutes that excluded banks from non-favored states.[65]

These laws, designed to protect local banks and encourage the development of viable regional institutions, were tolerated despite their discriminatory impact because they were consistent with longstanding congressional policy to permit local autonomy over issues of geographical expansion.[66] The 1994 legislation, however, signalled a sea change in congressional attitude toward state experimentation. With a few exceptions,[67] state authority to place conditions on entry by out-of-state banks was revoked, resulting in uniform national rules for interstate bank acquisitions.[68]

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which it is located; unlike 12 U.S.C. § 36(c), the statute made no reference to state branching laws. Thus, according to the Comptroller, a national bank could move its headquarters across state lines yet retain its existing branches in its former home state.

By August 1995, the Comptroller had approved 32 main office relocations by national banks to sites where, because of state branching restrictions, the banks could not have opened a new branch. In seven cases, state-chartered banks converted to national charters just to take advantage of section 30(b). *See* Justin Fox, *In a First, Texas Suing To Block Interstate Entry Under 30-Mile Rule*, AM. BANKER, Aug. 30, 1995, at 2.

Future main office relocations may be affected by recent interstate banking legislation. After May 31, 1997, whenever national banks relocate their main offices across state lines, offices left behind in their former home state will be considered new branches for the purposes of relevant state branching laws. *See* Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. 103-328, 108 Stat. 2338, Rev. Stat. 5155(e)(2). Moreover, a group of state banking commissioners has challenged the Comptroller's reading of section 30(b). *See* Brett Chase, *State Regulators Taking Aim at the 30-Mile Rule*, AM. BANKER, Feb. 2, 1996, at 4.

63. Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, *supra* note 62 (P. L. 103-328, 108 Stat. 2338).

64. As of August 1995, only Texas had adopted opt-out legislation. *See* Fox, *supra* note 62, at 2.

65. *E.g.*, Northeast Bancorp v. Board of Governors, 472 U.S. 159 (1985) (reviewing New England interstate banking compact).

66. *Id.* (upholding legality of New England interstate compact under federal banking statutes and the commerce, equal protection and interstate compact clauses of the U.S. Constitution).

67. *See infra* note 68.

68. Riegle-Neal preserves state "age" laws blocking acquisitions of newly formed banks, *see, e.g.*, FLA. STAT. ANN. § 658.295(3)(b) (West 1984 & Supp. 1996); IOWA CODE ANN. § 524.1906.3 (West 1993), but federal regulators may ignore these laws when the target bank is more than five years old. Rev. Stat. § 5154(a). State laws relating to community investment, consumer protection, fair lending and the establishment of in-state branches still generally apply to national bank branches, but the

States retain some autonomy to opt out of interstate banking. They still may bar interstate mergers and must authorize interstate branching before the Comptroller of the Currency may approve new national bank branches within their jurisdictions. Nevertheless, the practical effect of federal preemption is to discourage opting out. States may no longer prevent out-of-state bank holding companies from entering by buying the stock or assets of in-state banks. If states want to allow mergers between their banks and banks in contiguous states, they must permit all mergers. Moreover, if states permit interstate mergers, restrictive branching rules cannot prevent entry by out-of-state banks. Thus, although Congress stopped short of wholesale preemption of state law, the national policy of encouraging interstate banking is likely to prevail over more restrictive state policies.[69]

C. *Deposit Insurance*

Federal insurance of bank deposits is often blamed for much federal regulation, or overregulation, of banks. Government exposure to losses in the event of bank failure provides a justification for regulation aimed at preserving bank safety and soundness, occasionally at the expense of beneficial risk-taking and experimentation. These rules would be unnecessary were the deposit insurance guarantee to be limited or eliminated, allowing private risk-bearers to police their banks. Bank chartering authorities would then be free to participate in the race to a more deregulatory equilibrium.

To the extent that there is political will to shrink the deposit insurance system (and the responsibility that it imposes on federal regulators to supervise the banking industry), the impetus is coming from the national government, not from the states. In 1995, Representative Jim Leach introduced federal financial reform legislation that would allow national and Federal Reserve member banks to opt out of the federal deposit insurance scheme.[70] The legislation

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Comptroller of the Currency may ignore these laws too if they to discriminate against the national bank. Rev. Stat. § 5155(f)(1)(A).

One area where states retain limited discretion to resist the federal trend toward interstate banking is their power to set deposit caps limiting the percentage of total in-state deposits that may be controlled by any single banking institution. Although not a complete barrier to interstate banking, deposit caps may discourage entry by some out-of-state banks as well as limit in-state mergers. As of late 1995, 21 states had deposit caps ranging from 40 percent to as low as 10 percent. *See, e.g.*, IOWA CODE ANN. § 524.1802 (10 percent cap); *see also* Brett Chase, *Bigger Players Battle States Over Caps on Deposits*, AM. BANKER, Dec. 19, 1995, at 4.

69. At least some states continue to do battle at the margin to resist federal policy. One example is the deposit cap legislation described in *supra* note 68. Another is legislation currently under consideration in Kansas that would give the state banking commissioner discretion to block mergers that result in downsizing involving the loss of a significant number of in-state jobs. Bill McConnell, *Kansas Bill Would Enable State to Bar Mergers Involving Layoffs*, AM. BANKER, Feb. 1, 1996, at 2. Like deposit caps, this legislation technically would not discriminate against out-of-state entrants; nevertheless, this may be its practical effect.

70. Financial Services Competitiveness Act of 1995, H.R. 1062, § 117. As described in Subsection II.A.2 *supra*, this legislation did not reach the House floor in 1995.

would create a new class of wholesale financial institutions that would accept only large uninsured deposits but that could retain other privileges currently afforded banks (such as access to the Federal Reserve's discount window). Wholesale financial institutions would be subject to less regulatory oversight and would have correspondingly greater powers than federally insured banks.

The creation of uninsured wholesale financial institutions would represent a significant change from current federal law that requires national banks and state-chartered banks that become Federal Reserve members to participate in the deposit insurance scheme.[71] In contrast, under federal law, participation by state-chartered nonmember banks is voluntary. Nevertheless, since the wave of bank failures during the 1980s, most states have chosen to encourage all state-chartered banks to maintain federal deposit insurance.[72] As a result, federal preemption of state law would be required to give state-chartered banks the power to opt out of federal deposit insurance and enjoy the privileges afforded to wholesale financial institutions.

A state's decision to require its banks to obtain federal deposit insurance has an obvious economic motive: states thereby shift the cost of bank failure resolution to the federal government. Yet by granting a federal agency, the Federal Deposit Insurance Corporation, regulatory authority over their banks, states also relinquish some of their discretion to compete for bank charters by adopting banker-friendly rules.[73] Again, states appear willing to accept more regulation of their banks than the competitive story of bank chartering would suggest.

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71. Federal Deposit Insurance Act sec. 4(b), 12 U.S.C. § 1814 (1994).

72. Federal deposit insurance is mandatory in at least fifteen states. *E.g.*, ALA. CODE § 5-5A-12 (1981); ARIZ. REV. STAT. ANN. § 6-204 (1989); CONN. GEN. STAT. ANN. § 36a-70 (West 1995); FLA. STAT. ANN. § 658.38 (Supp. 1995); HAW. REV. STAT. § 412:3-201(8) (1993); ILL. REV. STAT. ch. 205, para. 5/13(c) (Smith-Hurd 1993); LA. REV. STAT. ANN. § 6:216 (West 1986 & Supp. 1995); ME. REV. STAT. ANN. § 9-B-422 (West 1980 & Supp. 1995); MD. CODE ANN., FIN. INST. § 5-509 (1992); NEB. REV. STAT. § 8-702 (1991); NEV. REV. STAT. ANN. § 661.015 (Michie 1992 & Supp. 1995); N.C. GEN. STAT. § 53-9.1 (1994); OHIO REV. STAT. § 1101.061 (Anderson 1988); UTAH CODE ANN. § 7-3-3(3) (1995); WYO. STAT. ANN. § 13-2-103 (1993). Alaska allows its state banking commissioner to mandate federal deposit insurance, ALASKA STAT. § 06.05.355 (1995). New Jersey mandates federal deposit insurance but permits its commissioner to grant exceptions, N.J. STAT. ANN. § 17:9A-15 (West 1984). Several states give their banks the alternative of purchasing private insurance or self-insuring, *e.g.*, GA. CODE ANN. § 7-1-244 (1989) (FDIC or private insurance); KAN. STAT. ANN. § 9-1301 (1991) (FDIC or fidelity bond); COLO. REV. STAT. ANN. § 11-3-105(7) (West 1990 & Supp. 1995) (FDIC or double liability for shareholders). Nevertheless, the potential loss of deposits to insured national banks operating in these states may make federal deposit insurance a less costly option for many banks.

73. For example, the Federal Deposit Insurance Act generally prevents insured state chartered banks from engaging as principal in any activity not permissible for national banks. Federal Deposit Insurance Act § 24, 12 U.S.C. § 1831a (1994). Assume that State X, facing the loss of bank charters to the national sovereign, decides to allow its banks to act as insurance underwriters, an activity currently not permissible for national banks. If State X requires its banks to be federally insured, its banks may not exercise their new underwriting power unless national banks are first given the same power. Thus, State X cannot compete for charters by promising its banks broader powers than the national sovereign.

D. *Consumer Regulation*

Although the states traditionally regulate consumer credit transactions involving local borrowers,[74] federal preemption occasionally is necessary to protect the profitability of nationwide bank credit operations from restrictive state laws. One example is the federal exportation principle that permits banks with nationwide credit operations to ignore variations in state usury ceilings. National banking laws permit a national bank to charge borrowers the highest rate of interest allowed by the laws of its home state.[75] In 1978, the Supreme Court ruled that national banks could apply their home state's usury limits to credit transactions conducted in any state regardless of local law.[76] Two years later, Congress extended the right to export interest rates to state-chartered banks with national credit operations.[77]

The exportation principle encouraged the growth of interstate credit operations by permitting banks to charge a single rate of interest to all credit cardholders or mortgage customers. It also stimulated some competition for bank charters, as a few states, notably Delaware and South Dakota, lowered their usury ceilings to attract or retain bank credit operations.[78] Nevertheless, regulatory competition did not produce a deregulatory equilibrium. While Delaware and South Dakota eliminated usury ceilings and invited out-of-state banks to relocate their credit card operations, other states, including Pennsylvania[79] and California,[80] adopted more restrictive regulation of consumer credit terms, prohibiting credit card late payment fees. Predictably, the Comptroller of the Currency took the position that these credit-related charges are "interest" and therefore governed by the exportation principle.[81]

The practical result of the exportation principle is that so long as any single state weakens or eliminates restrictions on credit terms or charges, lenders operating out of that state can ignore the more restrictive credit laws of every other state. Although, in theory, the federal solution defers to state usury laws,

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74. For an analysis and critique of the conflict of laws rules that permit this result, see Peter V. Letsou, *The Political Economy of Consumer Credit Regulation*, 44 EMORY L.J. 587 (1995).
75. 12 U.S.C. § 85 (1994).
76. Marquette National Bank v. First of Omaha Serv. Corp., 439 U.S. 299 (1978).
77. 12 U.S.C. § 1831d(a) (1994).
78. *See* Burgess & Ciolfi, *supra* note 7, at 936.
79. *See* Mazaika v. Bank One, Columbus, 653 A.2d 640 (Pa. Super. Ct. 1994).
80. *See* Smiley v. Citibank (South Dakota), 900 P.2d 690 (Cal. 1995), *cert. granted*, 64 U.S.L.W. 3500 (U.S. Jan. 19, 1996) (No. 95-850).
81. *See* 61 Fed. Reg. 4849, 4858 (Feb. 9, 1996) (adding 12 C.F.R. § 7.4001 providing that late fees are interest for the purposes of the federal exportation principle). Most courts agreed. *See, e.g.*, Smiley v. Citibank (South Dakota), 900 P.2d 690 (Cal. 1995); Greenwood Trust Co. v. Massachusetts, 971 F.2d 818 (1st Cir. 1992). *But see* Mazaika v. Bank One, Columbus, N.A., 653 A.2d 640; Sherman v. Citibank (South Dakota), 1995 N.J. Lexis 1354 (N.J. Sup. Ct. 1995); Hunter v. Greenwood Trust Co., 1995 N.J. Lexis 1354 (N.J. Sup. Ct. 1995) (state prohibitions on late charges are not preempted by federal law). The Supreme Court is expected to resolve this conflict in 1996.

in practice, it selects as the uniform national rule the most favorable bargain that banks can strike with any single state legislature. Again, federal preemption is being used to trump more restrictive state regulation of financial institutions.

III. Devolution and Reregulation: A Public Choice Explanation

As Part II described, in significant areas of bank regulation, deference to state experimentation has produced more restrictions on financial activities, requiring federal preemption to achieve deregulation. This raises the question why devolution is associated with enhanced regulation in the financial area. A public choice analysis would suggest that state legislators are vulnerable to rent-seeking by local interest groups that benefit from regulation.[82] These may include insurance agents, small banks, local businesses, and consumer groups, the classic "Main Street" coalition.

If correct, public choice analysis undercuts a compelling justification for devolution—that the states are less susceptible to interest group capture, more responsive to their citizenry, and more amenable to regulatory experimentation than the national sovereign.[83] It also casts doubt on the competitive story, which argues that states have financial incentives to attract bank charters by adopting deregulatory policies. To the contrary, at least some states appear willing to sacrifice chartering revenues in order to curry favor with in-state firms that prefer to maintain regulatory subsidies.

A. *Fees, Not Powers, Drive Charter Competition*

Why would some states risk losing chartering revenues to the national sovereign by adopting more restrictive, less banker-friendly regulatory policies? One possible explanation is that states are not sacrificing chartering revenues because restrictive state laws have not caused banks to defect to a national charter. There is evidence to support this hypothesis. Between 1991 and mid-1995, states experienced a net gain in bank charters at the expense of the national chartering authority despite the Comptroller of the Currency's promise to expand national bank powers.[84] The national chartering authority suffered a particularly serious loss in 1995 when Chase and Chemical opted to retain Chemical's New York state charter following their merger, costing the

82. *See* Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976) (explaining this economic theory of regulation).

83. *Cf.* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 5 (1993) (discussing superiority of state over national lawmaking).

84. *See* Justin Fox, *Stampede Toward State Charters Makes the OCC Change Its Tune*, AM. BANKER, Aug. 28, 1995, at 3.

Comptroller's office more than $8 million in yearly fees.[85]

National chartering fees, and their impact on bank chartering decisions, may explain why many states have managed to retain bank charters without committing to deregulation. For the bank opting among chartering authorities, fees may be a more significant consideration than powers. Bank chartering fees must cover the cost of regulatory examinations as well as administrative expenses associated with the chartering process. National chartering fees tend to be higher than state chartering fees, reflecting the relatively higher salaries paid to national bank examiners and the higher cost of national bank examinations.[86] For banks facing mounting pressure from their investors to operate more efficiently, economizing on chartering fees is an easy way to reduce fixed operating expenses.[87]

Although the national chartering authority has incentives to lower chartering fees to discourage defections, its relatively higher administrative costs limit its ability to compete with the states on the basis of fees.[88] Moreover, as defections occur, lost chartering revenues force the national chartering authority to downsize.[89] This dilemma may explain recent moves by the national sovereign to expand bank powers unilaterally. If the profits that national banks can expect from greater investment opportunities are sufficient to offset the premium that they must pay for the national charter, they may be persuaded not to defect.

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85. *See* Justin Fox, *In Blow to OCC, N.Y. Megabank Will Go with a State Charter*, AM. BANKER, Aug. 31, 1995, at 1.

86. States share the cost of examining Federal Reserve member and insured nonmember banks with the Federal Reserve and FDIC. As a result, their examination expenses are lower than those of the Comptroller, whose office has sole examination responsibility for national banks. *See* Fox, *supra* note 84, at 3. In the past, the Federal Reserve and FDIC have not charged state-chartered banks for their examinations. Recent proposals to change this policy have been assailed as an attack on the dual banking system by those who fear that state-chartered banks, facing significantly higher fees, would have financial incentives to convert to a national charter. *See* Justin Fox & Olaf de Senerpont Domis, *Clinton Revives Plan to Charge Fees for Exams of State Banks*, AM. BANKER, Dec. 12, 1995, at 4.

87. A related factor may also be at play. Because of the close working relationship between a bank and its primary regulatory authority, the reputation of the regulator matters. National bank examiners have been reputed to be the toughest (and, according to some sources, the most unreasonable) of the federal bank examiners. *See* Fox, *supra* note 84, at 3. Banks that prefer to deal with the Federal Reserve or FDIC as their primary federal regulator have incentives to choose a state charter. The Comptroller's recent effort to compete more effectively for bank charters has involved more than simply promising greater powers to national banks; the Comptroller's office is also trying to improve the public image of its examination staff. *Id.* at 3.

88. The Comptroller did lower fees somewhat in 1996. Nevertheless, fees remain significant, including, for 1996, (1) new charter filing fees of $14,300; (2) assessments, based on consolidated assets, ranging from $3158 for banks with assets of $2 million to over $2.1 million for banks with assets of $40 million; (3) examination fees of $49 per hour; and (4) franchise fees of $1500 for banks acting as municipal or government securities dealers. *See* Notice for 1996 Fees, OCC 95-66, Fed. Banking L. Rep. (CCH) ¶ 35-451 (Dec. 1, 1995).

89. This has been the consequence of recent charter losses. With fewer banks to supervise (and to pay fees), the Comptroller's office has been forced to reduce its examination staff. Some examiners have moved to the Federal Reserve, whose stable of banks has increased. *See* Olaf de Senerpont Domis, *OCC Losing Seasoned Examiners As It 'Rightsizes' Its Work Force*, AM. BANKER, Dec. 13, 1995, at 4.

As a practical matter, however, many banks cannot exploit new powers because of significant start-up costs. Moreover, individual preferences differ as to the optimal diversification strategy. Some banks are more interested in becoming investment bankers than in becoming insurance agents; others may have no interest in either activity, preferring to become travel agents. To persuade every potential defector to retain its national charter, the Comptroller would have to diversify the menu of new national bank powers well beyond existing statutory limits.[90] Finally, the recent profitability of the core banking business may make new powers less of a priority for many banks.[91] Thus, at least at present, states are apparently winning the charter competition without offering additional regulatory favors to banks.[92]

B. *Local Banks Cannot Capture the Benefits of Deregulation*

Variations in chartering fees cannot account for the absence of real competition for bank charters among the states. In the past, intrastate charter competition was assumed to be minimal because restrictions on interstate banking required banks looking to move between state chartering authorities to relocate their deposit-taking operations as well.[93] Nevertheless, this impediment to interstate charter competition was created by the states themselves. Each state had discretion to permit or restrict ownership of in-state banks by out-of-state bank holding companies.[94] Therefore, any state could choose to compete for charters by simultaneously expanding the powers of state banks and inviting out-of-state banking organizations to enter by chartering a new bank affiliate or by expanding an existing bank.

A few states did adopt this strategy. One of the first was South Dakota, which in 1983 adopted "emergency" legislation permitting state-chartered banks to engage in all facets of the insurance business.[95] At the time, most

90. National banking law limits banks to the business of banking and "all such incidental powers as shall be necessary to carry on the business of banking," 12 U.S.C. § 24 (para. seventh) (1994). Although federal courts defer to the Comptroller of the Currency's interpretation of this language, *see, e.g.*, Nationsbank of North Carolina, N.A. v. Variable Annuity Life Ins. Co., 115 S. Ct. 810, 814-17 (1995) (upholding Comptroller's ruling that sale of annuities is a permissible national bank power), there may be limits to what activities the Comptroller may reasonably decide are incidental to banking. *See, e.g.*, Arnold Tours, Inc. v. Camp, 472 F.2d 427, 438 (1st Cir. 1972) (rejecting Comptroller's ruling that operating a travel agency is a permissible activity for national banks).

91. *See, e.g.*, Justin Fox, *Bank Profits Rose 17% in 3Q, Fueled by Refund on Premiums*, AM. BANKER, Dec. 14, 1995, at 2.

92. The national sovereign may be content to attract a few large banks that value opportunities to diversify. Nevertheless, the competitive story posits that the states will respond to changes in national chartering law by broadening their own banks' powers, thereby leading to a competitive equilibrium. As the next section will explain, however, the majority of states have no incentive to deregulate in order to compete for a finite number of expansion-minded banks, especially when a larger pool of smaller banks may prefer more restrictive state law. *See infra* Section III.B.

93. *See supra* note 7.

94. *See supra* Section II.B.

95. S.D. CODIFIED LAWS § 51A-4-4 (1990).

chartering authorities barred banks from virtually all insurance activities.[96] The goal of the South Dakota legislation was to persuade out-of-state bank holding companies to charter new banks in South Dakota (or to contribute resources to an existing South Dakota bank) just to take advantage of this special opportunity to diversify. One such organization, Citicorp, committed to invest $2.5 million in a facility in Rapid City and to employ at least 100 to 150 South Dakota residents.[97]

South Dakota's legislation is a good example of successful rent-seeking by expansion-minded banks at the expense of local interests. The law was expressly designed to benefit out-of-state bank holding companies that would pay for expanded powers by bringing jobs and tax revenues to South Dakota. Although the statute originally prohibited out-of-state entrants from competing for South Dakota customers to the detriment of local financial institutions, it was still vigorously opposed by South Dakota banks and insurance interests.[98] That the statute was passed despite powerful local opposition suggests that out-of-state banking organizations like Citicorp were willing to pay more for deregulation than in-state institutions could pay to defeat it.

Nevertheless, contrary to the competitive story, South Dakota's initiative did not commence a regulatory competition in which other states vied to attract or retain bank charters by liberalizing their own laws. Over the next twelve years, a few states gave their banks expanded insurance powers,[99] but as many or more states resisted the competition, retaining or strengthening local barriers between banking and insurance.[100] This raises the question why expansion-minded banks succeeded in bargaining for deregulation in some states but failed in others.

One possible reason is that, having obtained favorable legislation in one state, expansion-minded banks did not need to bargain with other state legislatures. If establishing an insurance bank in South Dakota allowed a bank holding company to market insurance nationwide, once every expansion-minded bank holding company had chartered a bank in South Dakota, the competition would be over. Subsequent commitments by other states to follow

96. *See* Note, *Paving the Way in the Financial Services Industry: South Dakota Opens the Insurance Industry to Banks*, 29 S.D. L. REV. 172, 179 (1983).

97. *See Citicorp, Order Denying the Acquisition of a Bank*, 71 FED. RES. BULL. 789 (1985) [hereinafter *Citicorp*].

98. *See* Independent Community Bankers Ass'n of South Dakota v. South Dakota, 346 N.W.2d 737 (S.D. 1984). Challengers included the Independent Community Bankers Association, representing local banks, and three local insurance trade groups, the Professional Insurance Agents of South Dakota, the South Dakota Association of Life Underwriters, and the Independent Insurance Agents of South Dakota.

South Dakota's effort to protect in-state institutions from competition ultimately proved counterproductive. The Federal Reserve Board refused to permit Citicorp to acquire a South Dakota insurance bank on the ground that a South Dakota bank that would engage in no financial business in South Dakota was a sham. *Citicorp*, *supra* note 97.

99. These included California in 1988 and Delaware in 1990. *See supra* note 37.

100. *See supra* note 38.

South Dakota's lead would not persuade these banking organizations to defect.[101]

Nevertheless, state autonomy over regulation of financial institutions means that a single state like South Dakota cannot win the competition so easily. To the extent that states have asserted the power to determine who may sell insurance within their borders, they may close important markets to out-of-state banks.[102] The same problem affects banks seeking more favorable interstate branching or consumer credit regimes. Except in those cases where federal preemption allows banks to ignore local regulatory barriers,[103] each state retains control of the conduct of a financial business within its borders. For banks seeking to do an interstate business, negotiating favorable changes in the laws of their chartering authority may not be sufficient.[104]

Thus, past decisions by the national sovereign to delegate regulatory authority to the states mean that expansion-minded banks contemplating a nationwide business may be forced to bargain with fifty state legislatures. These banks could decide to avoid states with unfavorable laws, but some of the most restrictive states, such as Florida, control access to some of the most desirable customer markets. Rather than investing resources to achieve more banker-friendly state law, however, expansion-minded banks have usually responded by mounting legal challenges to local regulation.[105] Again, this raises the question why bargaining for deregulation at the state level has been so difficult.

The answer may be that the banks willing to invest in deregulation are too geographically dispersed and poorly organized to bargain for favorable results

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101. Other states might persuade bank holding companies to defect by offering a better deal than South Dakota's, for example, by promising insurance powers plus financial incentives to relocate. At some point, however, the value of the deal for the state would decline so far that the state would have little incentive to compete at all. Moreover, South Dakota might still be able to retain bank charters despite moves by other states to copy its lead if South Dakota's commitment to maintain a banker-friendly legal regime were more credible than that of other states—for example, because South Dakota is more dependent on tax revenues from the banking industry than other states with more diversified economies. *Cf.* Bratton & McCahery, *supra* note 10, at 1879-80 (describing Delaware's commitment to maintain its favorable corporate legal regime as contributing to its success in corporate charter competition).

102. *See supra* Subsection II.A.1.

103. *See supra* text accompanying note 76 (describing federal exportation principle that allows banks to ignore variations in local usury ceilings).

104. *Cf.* Letsou, *supra* note 74, at 658-70 (noting this problem with respect to current conflict of laws rules relating to consumer credit regulation and arguing that change in these rules to apply the law of lender's place of business rather than the law of borrower's place of residence to consumer credit transactions would improve regulatory competition).

105. *See, e.g.*, cases cited in notes 43 and 81, *supra*. Mounting piecemeal legal challenges to state law is costly, but apparently less costly than legislative bargaining. The explanation may be that the legal issues involved in individual cases are similar enough that individual banks economize on legal costs by sharing research and expertise. Moreover, in challenging state law, banks often enjoy the support of the national sovereign. Finally, expansion-minded banks usually prevail in legal challenges to state restrictions, particularly in the federal appellate courts. In contrast, their track record in bargaining for favorable legislative outcomes is much more disappointing.

in every state, particularly when their efforts are opposed by more cohesive organized local financial interests. These local interests that oppose deregulation often include local banks as well as rival financial firms; for example, in South Dakota, local banks joined with the local insurance industry to fight changes in state law that permitted bank insurance sales.[106] Local bankers' support for limitations on their own powers seems counterintuitive, particularly since many observers believe that local banks could compete quite successfully with independent insurance agents.[107]

Nevertheless, local banks cannot retain the gains from deregulation at the state level. If their state's law becomes more banker-friendly than the laws of rival chartering authorities, new banks will enter, increasing competition.[108] The new entrants, usually subsidiaries of expansion-minded bank holding companies, are likely to be better capitalized, better diversified, and more aggressive risk-takers than local banks. Even if local banks favor greater powers, the competitive threat posed by potential new entrants may persuade them to join with insurance agents and other affected interests to defeat deregulation.

Thus, public choice analysis offers an explanation of why, instead of moving bank chartering authorities toward regulatory equilibrium, regulatory competition among the states has produced many different local bargains. Although there are banks that can be persuaded to commit resources to states that adopt deregulatory policies, these expansion-minded banks represent only one of many interest groups with a stake in local financial regulation. In negotiating for deregulation, expansion-minded banks may face opposition from a coalition that includes not only rival financial institutions (like insurance agents) but also small local banks that have an interest in protecting their turf from new entrants.

Moreover, when local interests organize, they are likely to be more effective political actors at the state level than expansion-minded banks, which as outsiders are unfamiliar with local political practices. Local bankers and insurance agents act through local trade organizations that are repeat players

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106. *See supra* note 98.

107. *See, e.g.*, John Kimelman, *A Natural Next Step for Bank Marketers?*, AM. BANKER, Nov. 10, 1995, at 3A (suggesting that banks could draw on preexisting customer relationships and distribution systems to market insurance products and that major insurance underwriters are eager to sell insurance through banks).

108. Theoretically, local banks could bargain for increased insurance powers for themselves but higher barriers to entry by out-of-state banks. For example, Florida's prohibition on affiliations between banks and insurance agents exempts unit banks (banks that are not part of holding company structures) located in cities with populations of less than five thousand. *See* FLA. STAT. ANN. § 626.988(1)(a) (West 1984 & Supp. 1996). Nevertheless, without a credible commitment by out-of-state banks to contribute new resources to the state, local banks may not have the clout to bargain for favorable legislative changes for themselves, particularly when they face opposition from equally powerful local insurance interests.

in the state legislative bargaining process.[109] In contrast, out-of-state bankers often have no preexisting relationships with individual state legislators. Although these banks make may an initial commitment of resources in return for favorable changes in the state's legal regime, local legislators may distrust their willingness to maintain and expand their local investments over the long term.[110] In contrast, local financial interests have reason to build reputational capital by honoring their commitments to legislators.

Local interests are also likely to be effective actors at the state level because they often have a larger stake in the outcome than expansion-minded banks. If State X repeals its interstate banking restrictions, each of its local banks may risk a substantial loss in the value of its franchise. In contrast, the expected gain to each out-of-state bank that plans to enter State X may be small (for example, State X's deposit pool may be limited and must be shared with multiple new entrants). Therefore, State X's local banks have reason to devote greater resources to defeating reform than expansion-minded banks will contribute to achieving reform.

This suggests that where local banks have enough political clout to bargain for legislative outcomes, but not enough economic clout to risk competitive challenges from new entrants, they will invest substantial resources to oppose deregulation. Conversely, where the local financial industry is weak and not effectively organized, expansion-minded banks can more easily overcome opposition to deregulation.[111] This may explain why Delaware has recently taken the lead in bank deregulation at the state level.[112] Delaware was not a major financial center when its legislature decided to allow bank entry into insurance, so expansion-minded banks faced relatively weak opposition when they bargained for deregulation. Today, thanks to the commitment of resources by out-of-state bank entrants, the banking industry has become Delaware's

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109. *See, e.g.*, *supra* note 98 (citing local South Dakota trade organizations that opposed insurance legislation).

110. The terms of South Dakota's bargain with out-of-state bank holding companies, see *supra* note 98, suggests an attempt to address this concern. Although South Dakota could insist that out-of-state bank holding companies commit a level of resources to the state as a condition to entry, the legislature could not count on these companies to conduct their business in ways that would benefit South Dakota. For example, the new entrants could drain deposits from the state rather than reinvesting them in loans to South Dakota customers, or they could employ pricing practices that would drive local financial firms out of business. Moreover, since the new entrants had ties with multiple states, they could simply relocate should South Dakota attempt to punish these behaviors. South Dakota's solution was to welcome out-of-state entrants but bar them from competing for South Dakota banking or insurance customers, thereby externalizing these potential costs.

111. In some states, the local financial industry may be dominated by large expansion-minded institutions that are not afraid of competitive challenge. For example, the banking industries in California and New York might be expected to bargain successfully for local deregulatory policies. In fact, California was one of the first states to allow bank entry into the insurance business. *See supra* note 37.

112. South Dakota may have been targeted by expansion-minded banks in the 1980s for the same reason, although local interests in South Dakota were powerful enough to bargain for some protection from competition from the new entrants. *See supra* note 110.

second-largest employer.[113]

C. *Congressional Silence Reflects the Failure of Competing Interests to Achieve Their Goals At the National Level*

The cost of bargaining for deregulation at the state level suggests that expansion-minded banks should concentrate their resources on obtaining deregulation at the national level through federal preemption. In bargaining for federal deregulation, expansion-minded banks begin with several advantages. As a group, they should be able to outspend factionalized local interests that have exhausted their resources in bargaining for restrictive state legislation. Moreover, because a national solution will displace more restrictive state laws, expansion-minded banks will not have to invest in bargaining at the state level.

This analysis suggests that financial deregulation is more likely to occur at the national than at the state level. Nevertheless, to conclude that deregulation is easier to achieve at the national level does not mean that deregulation is inevitable. Federal preemption of interstate banking restrictions in 1994 was a victory for expansion-minded banks, but they were less successful in 1995, when they failed to obtain either greater securities powers or preemption of state insurance restrictions.[114] In fact, the politics of financial reform in 1995 suggest that the local interests that successfully bargain for restrictive regulation at the state level have considerable clout in Congress as well.

It may be that these local interests do not have to commit the same level of resources as expansion-minded banks in order to achieve their goals at the national level. So long as Congress fails to preempt state regulation, local interests can preserve the benefits of their bargains. Moreover, Congress has strong incentives to remain silent. Given variations in the strength and preferences of local financial interests, national politicians may maximize their own political support by deferring to customized local bargains.[115] As a result, Delaware is free to continue to please its expansion-minded banking industry by granting new powers, while Florida is free to help its local financial institutions protect their turf.

Nevertheless, because national and state sovereigns compete for regulatory autonomy over financial institutions, congressional neutrality does not always protect local bargains. Even where Congress has ceded regulatory authority to

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113. *See* Olaf de Senerpont Domis, *Delaware's Champion of Banks Stating Case Nationally*, AM. BANKER, Sept. 8, 1995, at 3.

114. *See supra* Subsection II.A.2.

115. *See* Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265, 274-76, 281-84 (1990). Professor Macey cites federal deference to state bank branching restrictions as an instance where political support maximization by national policy makers dictates deference to local solutions. *Id.* at 283. Nevertheless, in 1994, Congress chose to preempt at least some of these customized local solutions. *See supra* Section II.B.

the states, the national sovereign has incentives to expand its authority at the expense of state control. The Comptroller of the Currency's efforts to grant national banks new insurance powers is an example. Although McCarran-Ferguson permits states to regulate the business of insurance, the Comptroller's decision that annuities are a banking rather than an insurance product[116] limited the reach of restrictive state laws, frustrating the ability of local interests to enforce their legislative bargains.

To preserve their bargains, therefore, local interests are forced periodically to devote resources at the national level to persuade Congress to confirm state autonomy over financial regulation. In the past, local interests have been highly successful. In 1982, for example, Congress stopped the Federal Reserve from granting insurance powers to bank holding companies, thereby protecting state laws that barred affiliations between banks and insurance companies.[117]

In 1995, local interests again bargained at the national level to preserve state restrictions on bank insurance activities. House leaders eventually agreed to attach a moratorium on the expansion of national bank insurance powers to pending Glass-Steagall reform legislation.[118] Inclusion of the moratorium caused some expansion-minded banks to withdraw support for the legislation, delaying passage of the bill.[119]

This legislative deadlock may be evidence that expansion-minded banks are becoming more adept at bargaining at the national level. In the past, local interests were more effective coalition-builders, uniting small banks and insurance agents in support of state autonomy.[120] In contrast, expansion-minded banks quarrelled over priorities and were unable to form cross-industry alliances.[121]

The decision of major Wall Street securities firms to join with money center banks to support Glass-Steagall reform in 1995 signalled a significant shift in interest group power, creating a group that, although not powerful enough to achieve deregulation, may be able to defeat legislation that will halt further deregulatory initiatives on the part of the national sovereign.[122] Thus,

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116. *See supra* text accompanying note 33.
117. *See supra* note 19.
118. *See supra* Subsection II.A.2.
119. *See supra* text accompanying notes 51-52.
120. Insurance agents in particular have been a powerful interest group with great influence in Congress. In the early 1980s, the Independent Insurance Agents of America, the industry's national lobbying organization, represented 35,000 insurance agencies doing business in all fifty states. (In contrast, the American Bankers Association had 13,200 members.) *See* Daniel Hertzberg & Christopher Conte, *Bill Puts Crimp in Banks' Insurance Role As Insurers Wield Their Capitol Hill Clout*, WALL ST. J., Oct. 6, 1982, at 16.
121. While insurance agents had one issue—keeping banks out of their business—expansion-minded banks had multiple priorities; for some, securities powers were more significant than insurance. *Id.*
122. Collective action problems remain for expansion-minded banks. In 1995, when congressional leaders successfully demanded a moratorium on new national bank insurance powers as the price for supporting Glass-Steagall reform, the banking industry was divided. The Comptroller of the Currency

in 1996, congressional silence may reflect a standoff between two interest groups, each sufficiently powerful to block the other's effort to achieve its goals through federal legislation. Nevertheless, this equilibrium is inherently unstable; it is likely to break down as competing interest groups continue to vie for political influence.[123]

IV. Devolution and Deregulation: The Ideological Component

There may be another reason why national policy on issues of financial regulation has proved so unstable during the mid-1990s. Public choice analysis tends to ignore the role of ideology in influencing political outcomes. Adding ideology to the political equation is not necessarily inconsistent with rent-seeking explanations of legislative outcomes. Rather, it offers a different perspective on the rent-seeking process. Specifically, as applied to financial regulation, it may explain why legislative bargains at the national level are so difficult to reach and tend to be breached so rapidly.

Ideological preferences may affect interest group bargaining in several ways. The inability of affected constituencies to police lawmakers to enforce their bargains, called regulatory "slack" by some economists,[124] may free policy makers to pursue personal ideological goals. In this case, legislative results may be at odds with the expected outcomes of interest group bargaining. Alternatively, policy makers may appeal to ideology to shape public opinion

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lobbied banks to oppose the entire reform package if the moratorium remained. *See* Jaret Seiberg, *Comptroller to Bankers: Insurance Sales Crucial*, AM. BANKER, Oct. 10, 1995, at 1. In response, 36 bank chief executives signed a letter to House members criticizing the amended bill, but some key industry supporters of Glass-Steagall reform, such as J.P. Morgan, did not join with them. Bill McConnell, *36 CEOs Urge Gingrich to Kill Insurance Curbs*, AM. BANKER, Oct. 13, 1995, at 1. For banks like Morgan, Glass-Steagall reform apparently was more important than preserving the Comptroller's autonomy to expand national bank insurance powers. For other expansion-minded banks, insurance powers apparently were more significant than underwriting powers.

Bank trade organizations also disagreed. In October 1995, the Independent Bankers Association of America, a trade group for small banks, dropped its long-standing opposition to Glass-Steagall reform and endorsed the reform package, including the moratorium on new national bank insurance powers. In contrast, the American Bankers Association, long a supporter of Glass-Steagall reform, refused to endorse the legislation. *See* Bill McConnell, *IBAA Backs Leach Package, Saying Insurance Provision Isn't So Bad*, AM. BANKER, Oct. 11, 1995, at 2.

123. In 1996, in the Senate, expansion-minded banks had a powerful ally in Banking Committee Chairman Alfonse D'Amato, who favored federal legislation removing all barriers between banking and other commercial businesses. *See, e.g.*, Justin Fox, *D'Amato Aide Urges Jump-Start For Reforming Glass-Steagall*, AM. BANKER, Dec. 6, 1995, at 4. Moreover, the banking industry hoped that a favorable ruling from the Supreme Court in the *Barnett* case would, at least temporarily, resolve the issue of bank insurance powers, paving the way for Glass-Steagall reform. On the other hand, the Supreme Court decision was expected to increase pressure on Congress to adopt legislation reaffirming state control of bank insurance activities. Mindful of this conflict, Congressman Leach tried to regain support for his reform statute by brokering a compromise between the banking and insurance industries. Bill McConnell, *Banks, Divided Over Insurance, Fail to Rally Around Glass-Steagall Bill*, AM. BANKER, Jan. 4, 1996, at 3.

124. *E.g.*, Joseph Kalt & Mark Zupan, *The Apparent Ideological Behavior of Legislators: Testing For Principal-Agent Slack in Political Institutions*, 33 J.L. & ECON. 103 (1990).

and to provide their political bargains with the cloak of intellectual legitimacy. In this case, interest group bargaining accounts for legislative outcomes; ideology helps to mask the bargaining process from public view and criticism.

In financial regulation, ideology plays both roles. First, it fills in gaps in the public choice story. The clash of interest groups described in Part III is nothing new; the debate over financial regulation has always pitted large, expansion-minded financial institutions against small, local institutions. Interest group preferences are predictable, but individual legislators' willingness to reward one powerful interest group at the expense of another equally powerful interest group is less predictable. The personal ideological preferences of imperfectly monitored policy makers may provide an explanation.

Second, the inability of policy makers to articulate a clear ideological justification for legislative results may make the average legislator reluctant to commit to interest group bargains. Recently, legislative bargaining over financial regulation has been derailed by ideological dissonance, a factor that is working in favor of local pro-regulatory interests. Ironically, the problem results from the clash of two ideological preferences that are widely shared by policy makers and their constituents. Today's politicians on both sides of the aisle profess their commitment to the twin goals of shrinking the federal government and dismantling overly restrictive regulation that prevents free competition and economic growth. In financial regulation, however, these two ideals are inconsistent, creating a dilemma for legislators and for theorists who seek to understand and legitimize the legislative process.

A. *The Political Dilemma: Is Devolution Inconsistent With Deregulation?*

Traditionally, critics of financial regulation have focused almost exclusively on overregulation at the federal level. Many accepted without question the competitive story of bank chartering and assumed that state freedom to experiment with regulation would produce a desirable deregulatory equilibrium. In fact, however, a diminished federal role will mean that states are free to adopt and retain financial regulation that is protectionist and anticompetitive. Preemption of state regulation demands an enhanced federal role that is inconsistent with the ideological bent of today's politician.

This creates a dilemma for the legislator who is publicly committed to both deregulation and devolution. For example, in 1995, Republican House leaders who earlier in the year had made expansion of bank securities powers a priority eventually derailed their own reform legislation by including provisions that protected state laws barring bank entry into the insurance business.[125] Some of these legislators may have been swayed by campaign contributions from affected industry groups. Insurance agents in particular have traditionally been

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125. *See supra* Subsection I.A.2.

effective political actors at the congressional level.[126] Nevertheless, even Banking Committee Chairman Leach, who was close to the banking community and who had a personal reputational interest in Glass-Steagall reform, allowed his legislation to become a referendum on federalism.[127]

Representative Leach maintained publicly that he would have preferred legislation that was silent on the issue of bank insurance powers.[128] Nevertheless, opponents argued that congressional silence was not neutrality so long as the Comptroller of the Currency was free to interpret national banking laws to enhance the regulatory authority of the national sovereign at the expense of the states.[129] As debate over financial reform shifted from deregulation to devolution, congressional leadership could not afford to ignore this argument.[130]

Similarly, this argument could not be ignored by the average legislator who would eventually have to justify a vote for bank deregulation to her constituents. When the issue was simply Glass-Steagall reform, the legislation affected a relatively small group of large financial institutions that operated in the securities markets and was of little interest to the general public. Once federalism became the issue, however, the political stakes were higher. A vote for Glass-Steagall reform without the limitations on the national sovereign demanded by supporters of state autonomy could be portrayed by political opponents as a vote for big banks and big government. To be identified with both Wall Street and Washington would not enhance the reputations of most legislators in the mid-1990s.

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126. *See supra* note 120. For example, House Speaker Newt Gingrich reportedly told bankers that the moratorium was added to the securities reform bill for a simple reason: insurance agents can turn out more votes on the issue than bankers can. *See* Keith Bradsher, *No New Deal for Banking; Efforts to Drop Depression-Era Barriers Stall, Again*, N.Y. TIMES, Nov. 2, 1995, at D1.

Nevertheless, the political influence of independent insurance agents may be waning. First, due to competition from direct writers, independent agents' market share is shrinking. *See, e.g.*, Victoria Sonshine Pasher, *Shrinking Mkt Squeezes Personal Lines Agencies*, NAT'L UNDERWRITE PROPERTY & CASUALTY/RISK & BENEFITS MANAGEMENT ED., Aug. 14, 1995, at 3. Second, in their fight against bank entry, independent agents do not have the support of the insurance underwriters, most of whom would welcome banks as distributors of their products.

127. For the reaction of the banking industry, which had counted on Leach's leadership to achieve Glass-Steagall reform in 1995, *see* Bill McConnell, *Second Thoughts About Leach's Guidance*, AM. BANKER, Nov. 14, 1995, at 4.

128. Barbara A. Rehm & Bill McConnell, *Leach Wants A Bank Bill Without Ban On Insurance*, AM. BANKER, Oct. 27, 1995, at 1.

129. One of the chief advocates of this position was House Rules Committee Chairman Gerald Solomon, who was skillful in casting the issue as one of federalism. In his words, federal banking officials had "abused their power" by expanding national bank insurance powers in defiance of state law. Olaf de Senerpont Domis, *House Rules Chief Warns That Floor Procedure Could Kill Ban on Wider Powers*, AM. BANKER, Aug. 1, 1995, at 2. Depicted this way, the problem of bank insurance powers was more significant, and more urgent, than a skirmish between two interest groups seeking to expand their market shares.

130. *See* Robert M. Garsson, *Capitol Account: Leach Eyes End Run For Bank Legislation*, AM. BANKER, July 28, 1995, at 3 (noting that top House Republicans were beginning to side with the insurance industry's position).

Thus, the average legislator had reason to embrace an amendment that appeared to halt the expansion of national regulatory authority at the expense of state autonomy. Characterized as such, the amendment was consistent with the ideological preferences of the majority of policy makers, whether those preferences were honestly held or borrowed to appeal to constituents. Ironically, however, by supporting state autonomy, these congressional proponents of devolution were in the curious position of defending state-imposed entry barriers that retarded free competition for financial services—the very kinds of overregulation that they had pledged to abolish at the national level.

B. *The Theoretical Dilemma: Does Restrictive State Law Reflect Majoritarian Values?*

The conflict between the goals of financial deregulation and devolution also creates a dilemma for theorists seeking to understand the legislative process and to predict regulatory outcomes. For decades, most have assumed that economic deregulation was in the public interest.[131] In the case of financial institutions, deregulation promises greater convenience for consumers, lower transaction costs, and improved competitiveness in global markets where U.S. financial institutions once flourished but are in danger of losing their advantage.[132]

If financial deregulation is in the public interest, the question arises whether this public-regarding policy is more likely to inform legislative outcomes at the state or at the national level. Traditional regulatory competition theory assumed that states were willing to experiment with deregulation to the same extent as, or even to a greater extent than, the national government. Traditional public choice analysis supported the competitive story. Interest group bargaining, which persuades states to adopt banker-friendly laws in order to attract charters, should result in deregulation that ultimately benefits the public.

Experience with devolution in the financial area suggests that state autonomy does not necessarily lead to less regulation. This result can be

131. Since at least the 1980s, there has been broad academic consensus that economic regulation of fundamentally competitive markets (such as airlines) does not serve the public interest. *See, e.g.*, MARTHA DERTHICK & PAUL J. QUIRK, THE POLITICS OF DEREGULATION 238 (1985); Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167, 186-87 (Special Issue 1990); Michael E. Levine, *Revisionism Revised? Airline Deregulation and the Public Interest*, 44 LAW & CONTEMP. PROBS. 179 (No. 1, 1981).

132. For a statement of these public benefits of bank deregulation, see Modernizing the Financial System: U.S. Treasury Department Recommendations for Safer, More Competitive Banks, *supra* note 24, at 54-57. Of course, there are risks associated with bank deregulation that may be more serious than those associated with deregulation of other businesses; for example, increased rates of bank failure potentially impose costs on parties other than the failed bank and its stakeholders. *See* Helen A. Garten, *What Price Bank Failure?*, 50 OHIO ST. L.J. 1159, 1162-76 (1989) (describing various costs of bank failure). Nevertheless, assuming adequate safeguards are in place, expanding opportunities for banks to diversify may strengthen their capital and competitive positions, making failure less likely. *See, e.g.*, Modernizing the Financial System, *supra* note 24, at 56-57.

reconciled with both regulatory competition and public choice theories if some assumptions are changed to reflect the realities of the banking industry. Because regulatory competition in banking means that states vie for resources by opening previously closed local financial markets to new entrants, local financial interests, fearing increased competition, have reason to outspend expansion-minded banks in order to preserve local entry barriers.

The question arises whether this result is also consistent with majoritarian values. Several factors suggest that to dismiss restrictive state financial legislation as purely the product of rent-seeking by narrow industry groups may be too simple and that restrictive state law may reflect majoritarian values. Restrictive state regulation may not make the majority of people better off by maximizing the efficient allocation of resources (the opposite may be true).[133] Nevertheless, regulation may satisfy deeply held ideological preferences that are shared by a wide segment of the public.

In this respect, supporters of local financial regulation have been more successful than expansion-minded interests in appealing to ideology to justify their positions to the public.[134] Proponents of financial deregulation have had trouble convincing the public that freeing banks from regulation is in the public interest. Although they have cited the public benefits of enhanced competition, their arguments have been less compelling than similar arguments made in favor of deregulation of nonbanking businesses, such as airlines or trucking.[135] In the case of financial regulation, pro-regulatory interests have been able to undercut these arguments by appealing to deeply held public preferences for local autonomy, local experimentation, and the protection of local enterprise, concerns that have more relevance to banking than to airlines or trucking. For example, laws that protect the friendly local bank from acquisition by a large national chain appeal to a public that is convinced that bigger banks charge higher fees than local banks.[136]

In some cases, popular ideological beliefs result in consumer preferences that may be somewhat inconsistent. For example, a 1991 consumer survey conducted by the Gallup Organization and the American Banker found that two-thirds of the respondents agreed with the proposition "I prefer to do my banking at a smaller, local bank rather than at a larger bank."[137] Yet the survey also found that a majority of consumers were open to buying nonbank-

133. *See infra* notes 137-138.

134. Professor Letsou makes this argument with respect to state restrictions on coercive collection practices of consumer lenders. *See* Letsou, *supra* note 74, at 652-54.

135. *Cf.* DERTHICK & QUIRK, *supra* note 131, at 238-39 (noting that pro-competitive arguments in favor of airline, trucking, and telecommunications deregulation had broad political appeal).

136. *See, e.g.*, Matt Schulz, *Customers Pay a Premium for Banking With Out-of-State Institutions, Fed Finds*, AM. BANKER, Sept. 7, 1995, at 3.

137. Robert M. Garsson, *Uneasiness Mounts Over Health of System*, *in* AM. BANKER 1991 CONSUMER SURVEY, Jan. 1991, at 12.

ing financial products such as stock and bond mutual funds and annuities from their banks.[138] Presumably, larger banks are more likely than smaller, local banks to be able to offer the diversified package of financial products that many customers want.

Attitudes toward bank insurance sales reveal similar inconsistencies. A majority of bank customers said that they would buy annuities from their banks but only 35 percent would buy life insurance.[139] In 1995, banks represented just 1 percent of total life insurance sales.[140] Nevertheless, in recent years, traditional life insurance agents have neglected the low- and middle-income market.[141] Although sales of life insurance through bank branches seems an efficient way to reach this neglected market, bank entry has been frustrated both by the wariness of bank customers and by restrictive state laws that bar banks from marketing insurance products.[142]

Public distrust of deregulation has enabled state legislators to promote some restrictive state bank regulation, including prohibitions on bank insurance sales, as pro-consumer. Legislators typically cite the danger of coercive tying arrangements, whereby banks force consumers to buy insurance products as a condition to receiving credit, as the justification for restricting bank insurance sales.[143] Of course, this public-regarding justification may mask the legislature's real purpose of rewarding local banks and insurance agents. Nevertheless, politicians can successfully hide the legislative bargaining process from public view and criticism only if their public positions are consistent with popular values and beliefs. In this case, feeding public fear of the consequences of deregulation reflects and actually confirms public perceptions of the dangers of financial conglomeration.

Moreover, in passing restrictive regulation, legislators may be legitimately responding to the demands of consumer groups. Consumer groups have supported state prohibitions on late fees and other local consumer credit regulation.[144] Local community groups have cited consumer concerns in

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138. Judy Ferring, *Public Is Open to New Products*, *in* AM. BANKER 1991 CONSUMER SURVEY, Jan. 1991, at 18.

139. *Id.*

140. Kimelman, *supra* note 107, at 4A.

141. *Id.* at 3A.

142. *See supra* Subsection I.A.1.

143. *See supra* note 40 (discussing stated purpose of Florida legislation); *see also* First Advantage Ins. v. Green, 652 So. 2d 562 (La. Ct. App., 1st Cir. 1995) (citing prevention of tying as purpose of Louisiana antiaffiliation statute), *cert. denied*, 654 So. 2d 331 (La. 1995).

144. *See, e.g.*, 61 Fed. Reg. 4858 (noting opposition by consumer groups, as well as class action plaintiffs' attorneys, to the Comptroller's classification of late fees charged by national banks as "interest" subject to the exportation principle). *See also* Letsou, *supra* note 74, at 629 n.139 (acknowledging consumer group support for legal restrictions on contract terms defining lender remedies).

efforts to block bank expansions and mergers.[145] Thus, state legislators considering restrictive financial regulation may be able to count on local consumer groups to join the coalition in support of regulation.

Consumer support does not necessarily mean that state restrictions always benefit the public.[146] Consumer groups may share public fears that large, expansion-minded banks will be less responsive to local needs than small financial institutions. They may also feel some community of interest with local firms that are repeat players in the legislative bargaining process and may be trusted to keep their bargains.

Finally, support for deregulation will make leaders of consumer groups the political allies of large, powerful and often out-of-state banking institutions that will benefit from changes in state law. If consumer leaders are unable to convince their constituents that these institutions are truly committed to the welfare of local residents, they may suffer a serious decline in their own prestige and power. For this reason, consumer leaders will not take an active public role in lobbying for financial deregulation.

Therefore, state legislatures are unlikely to face serious opposition from consumer groups or the public when they enact restrictive bank regulation. In many cases, they may enjoy substantial public support. At the least, local politicians may be able to persuade their constituents that local experimentation is always preferable to uniform standards imposed by the national sovereign.

V. CONCLUSION

When states act to impose tighter restrictions on their banks than those favored by the national sovereign, their choices may be more responsive to public preferences than the deregulatory policies recently endorsed by the Comptroller of the Currency. Financial deregulation may reflect elitist rather than majoritarian values. This should come as no surprise to advocates of devolution, who have long argued that local rather than national government best represents the will of the people.

Nevertheless, this does suggest that devolution will not ignite a beneficial regulatory competition that will eventually produce a freer, less regulated banking system. Advocates of deregulation may have to rethink their strategy and find better ways of convincing the majority that, in the long run, restrictive

145. *See generally* Anthony D. Taibi, *Banking, Finance, and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice*, 107 HARV. L. REV. 1463 (1994).

146. For example, Professor Letsou offers two explanations for why consumer groups might favor restrictions on coercive collection practices by lenders that actually harm consumer welfare. First, these groups may incorrectly believe that the benefits of protecting defaulting borrowers outweigh the costs to consumers who pay their debt and must bear higher interest rates. Second, consumer groups may share popular anti-bank sentiment. *See* Letsou, *supra note* 74, at 629 n.139.

local financial regulation is to their disadvantage. Federal preemption of state law and the imposition of uniform national rules may seem to offer a quicker path to deregulation, but experience has shown that states always find ways to reassert power over financial institutions. Moreover, it runs counter to the philosophy of majoritarianism that is a basic tenet of today's conservative political movement.