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Statement of the Shadow Financial Regulatory Committee

On

The European Union's Financial Conglomerate Directive

May 5, 2003

The European Union (EU) has adopted, but not yet implemented, a directive that would require a financial company deemed to be part of a "financial conglomerate" based outside the EU to either (a) show that its foreign-based holding company is regulated by an "equivalent" consolidated regulatory authority outside of the EU, or (b) establish a holding company under EU regulation.

This directive would affect U.S. financial companies that combine financial activities, such as merchant banking, investment banking, insurance, and securities transactions, and that are not financial service holding companies. Such companies are not subject to consolidated oversight by the Federal Reserve under the Gramm-Leach-Bliley Act of 1999, and include some significant international financial institutions, such as Merrill Lynch and GE. For those firms, the EU directive would require either that they adopt one of the alternatives above or withdraw from, or avoid entering, the European financial marketplace. There has been speculation that additional options may be open to these firms to satisfy the EU directive. For example, it is possible that the EU will rule that the Securities and Exchange Commission (SEC) – which already regulates some of these firms' operations within the U.S. in a less intrusive manner than the Fed – would be deemed to be an "equivalent" consolidated regulator. Alternatively, it is possible that new regulatory relationships within the United States other than with the SEC or with the Fed under Gramm-Leach-Bliley might satisfy the new EU requirement (for example, the EU might deem that a state banking authority within the United States could play the role of an "equivalent" consolidated regulator for the purpose of satisfying the European directive).

None of these possibilities is attractive. The Shadow Financial Regulatory Committee previously has noted that there is no need for consolidated holding company regulation, especially if an insured deposit-taking bank is not part of the conglomerate organization (see Statements No. 139 and 174). The EU directive only imposes new regulatory burdens on financial conglomerates that do not include insured deposit-taking banks, and thus is a particularly undesirable form of consolidated holding company regulation. A preferable approach is to focus prudential regulation on the structure and transactions of insured deposit-taking banks, rather than regulate the behavior of all the entities within financial holding companies. The decisions of some financial firms to avoid becoming financial holding companies under the Gramm-Leach-Bliley Act likely reflect the potential costs of this extension of regulatory authority. The EU directive should not drive those firms to accept unnecessary regulation within the U.S. – whether by becoming financial holding companies under Gramm-Leach-Bliley, or in some other way. Establishing new layers of regulation within Europe also imposes unnecessary costs. The choice of avoiding the European market altogether means the loss of gains from trade from allowing efficient financial institutions to enter the European marketplace.

For these reasons, the Committee encourages the EU to adopt a flexible interpretation of regulatory equivalence for the purpose of satisfying the EU directive. The Committee believes that the key principles that should guide European, U.S., and other nations' policies toward regulating foreign entities are: (1) mutual recognition of the regulation of foreign holding companies with minimum prudential standards, and (2) national treatment of subsidiaries of holding companies from abroad.