THE DUAL STATE-FEDERAL REGULATION OF FINANCIAL INSTITUTIONS — A POLICY PROPOSAL

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INTRODUCTION

In 1983 South Dakota passed an Act permitting its chartered banks to sell and underwrite insurance.¹ The issue that I address is whether states should have the power to pass such a law. I am not concerned here with interpretation of positive law but with public policy implications.

The issue is a matter of congressional policy. Like most financial intermediaries banks are regulated by both state and federal laws,² but it is clear that the federal government has the power to preempt state laws that regulate banks. Therefore, whether South Dakota can pass the statute is not a question of constitutional mandate or "states' rights"³ but essentially a matter of congressional choice.

A theory guiding this choice is especially necessary today because there is much dissension among interest groups and regulators regarding the scope of bank regulation. Congress is being pressured to take conflicting approaches to bank regulation.⁴

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² The most notable exception is insurance regulation, towards which Congress has taken a hands-off attitude. See 1 T. FRANKEL, THE REGULATION OF MONEY MANAGERS I(D) § 12 (1978) (discussing the history of the McCarran-Ferguson Act of 1945).


⁴ These pressures were triggered by changing economic conditions and by technological innovations, which activated state governments and federal agencies. Actions by these governments and agencies, and by the markets and the industries, brought about
When interest groups are in sharp conflict, as they are now, Congress may be unable to act, even when legislative solutions are appropriate. Absent principled analysis, it is likely that decisions to act or to avoid action will be politicized, and Congress will not attempt to determine what is the best solution to a problem.⁶

What policies should guide Congress in allocating bank regulatory powers among state and federal governments? When should federal law preempt state law? Particularly, should the South Dakota statute be upheld or overruled by Congress?

To answer these questions, I first list the arguments for and against the current system and opt for the system. I then attempt to develop a test for allocating regulatory powers by focusing on a hypothetical “best regulator” and testing South Dakota against that hypothetical regulator. I conclude that South Dakota should be permitted to enforce its statute.

I. THE ARGUMENTS IN SUPPORT OF AND AGAINST THE DUAL SYSTEM

A. Checks and Balances

The main argument for the dual banking system is that it provides checks and balances to governmental power: the power to control the creation and concentration of money. The term “checks and balances” is usually used in the context of the constitutional relation among the three branches of the federal government. The dual system differs from the constitutional system in both its legal foundation and in the way it functions. Unlike the constitutional system, the dual banking system is a matter of congressional policy rather than constitutional interpretation.

The dual system disperses power. Regulatory power over banks is split not only among federal and state governments but also among four federal agencies.⁸ Furthermore, the branches of reactions by others, either following the change in the status quo, or resisting it. This process resulted in conflicting state and federal laws and their interpretation of existing laws.


⁸ The separation between state and federal regulation is not complete, since there are matters in which federal law is superimposed on state banks as well as federally chartered banks.
government to which these agencies are accountable are also split. The Office of the Comptroller is accountable to the Treasury. The Securities and Exchange Commission is accountable to Congress and is fully dependent on Congress for its budget. The Federal Deposit Insurance Corporation is also accountable to Congress but is more independent than the Commission regarding its budget. Finally, the Federal Reserve Board presides over a number of banks that are partially privately owned, and earns its own keep through services and safekeeping of reserves and is the least politicized and least accountable agency that regulates banks.\(^7\)

The dual banking system also contributes to the dispersion of the private powers of banks. States tend to protect their community banks from the competition of large banks by erecting barriers to entry and branching. Even without such barriers, the system tends to produce a larger number of small banks than would a unitary system of regulation. Consequently, private banking power, to which both citizens and governments have historically shown mistrust and hostility, is kept in check.

The system also functions differently from the constitutional model. Whereas the constitutional checks and balances are regulated mainly by the courts, the dual banking system is regulated mainly by “consumers” of regulation, including the regulated industry. Since power to regulate is triggered by the grant of bank charters,\(^8\) banks have numerous choices as to the regulatory system under which they operate.\(^9\) Furthermore, any bank may change from one regulatory system to another without the consent of its former regulator.\(^10\) States compete with one

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\(^7\) Historically, a number of states have established more than one bank regulator, and some commentators maintain that the dual system itself followed a model of state banking regulation.

\(^8\) Chartering is an unusual method of regulation for the federal government. The traditional federal method is through licensing, registration, or direct regulation of functions. The method most similar to bank regulation is that of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80b-21 (1982), which superimposes structural requirements on any form in which the promoters choose to organize an investment company.


another because they want to acquire and maintain control over the banks that they regulate. Reasons for this competition include the fees, taxes, jobs, and capital generated by the resident banks. South Dakota changed its laws for precisely these reasons: to attract revenues to, and generate revenues within, the state.

It should be noted, however, that even though the ability of banks to move to another jurisdiction puts pressure on the regulators, that pressure should not be exaggerated. It is expensive for a bank to move to another state. Moreover, states offer benefits other than their particular regulatory schemes. A wealthy population, which includes money-center activities and facilities, may induce a bank to remain in a state despite strict regulation.

In sum, the great value of the dual banking system is that it provides checks and balances on private and governmental power. The South Dakota statute manifests this value because it offers a check on an agency that may unwise and unjustly prevent banks from entering the insurance field.

B. Encouraging Better and Innovative Regulation

Another valuable feature of the dual banking system is that it encourages regulatory innovation by pitting the state and federal government against each other. Competition may lead to better, more effective and efficient regulation. Furthermore, there are ways to deregulate and remove legal constraints for the purpose of efficiency without destroying the dual system. In addition, in times of change, when experiments and innovations are particularly valuable, the dual banking system reduces the risk of adverse effects to the national system by limiting experiments to one state. The South Dakota statute provides a laboratory for testing the grant of insurance powers to banks. Viewed as an experiment in bank diversification, the South Dakota statute is desirable.

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II. Criticism of the Dual Banking System

A. Irrational Design

Critics of the system argue that regulation should be based on logic and economic theory, which require that we ignore past traditions and other values that have resulted in inefficient rules. Under these criteria the dual system is irrational and inefficient. For example, the system permits increases in the number of banks at the expense of efficiency. The short answer to this criticism is provided by Holmes’ characterization of the life of the law as experience, not logic. An organic law grows with the society that gives life to it. Therefore, a viable system of law is rational, much as a tree is rational, even though its branches are not symmetrical and its shape is not governed by the rules of geometry. Furthermore, reform is not synonymous with a rational drawing-board design. A tree “reforms” by bending with the winds; or, a tree may be “reformed” by pruning to eliminate dead wood and enhance growth. In addition, the dual system is rational because, under this system, experiments such as South Dakota’s can be conducted more safely than under the federal system.

B. Lack of Uniformity

Critics argue that efficient regulation is uniform, consistent, and predictable, since these features reduce costs both to the regulators and to the regulated industry. Conflicting and parallel rules are costly to the industry because they produce uncertainty. Efforts to reduce uncertainty through litigation and lobbying are also costly. Furthermore, a lack of uniform laws and their enforcement reduces industry competition because unequal laws give competitive advantages to some lines of business but not to other, similar lines of business.16

12 See Fein, supra note 3, at 700 (suggesting that present regulatory organization of depository institutions is illogical).
13 See Shy, Interstate Banking Restrictions of the International Banking and Bank Holding Company Act, 97 Banking L.J. 524, 535 (1980) (expressing concern about the concentration of banking and financial power that existed in 1956 when the Douglas Amendment was approved).
14 See, e.g., Fein, supra note 3, at 698 (present system lacks simple, efficient regulatory oversight).
15 See id. at 700.
The dual banking system produces conflicting and overlapping regulation. Since governments want to retain, if not increase, the number of institutions under their jurisdiction, they attract regulated enterprises by differentiating their regulatory “product” from that of other governments. The state and federal governments provide different standards of regulation or different governmental services. Therefore, critics of dual banking argue that the system produces laws that are inconsistent, ineffective, and unpredictable.\textsuperscript{18} It is argued that the same flaws appear in the enforcement and interpretation of these laws. In addition, the system produces delays in the administration of these laws.\textsuperscript{17}

These criticisms are valid. However, the alternative of one large agency controlling and regulating all banking institutions in this country is not necessarily more efficient. Such a behemoth may generate more regulation than is necessary and may be so bogged down by a large bureaucracy as to become totally unmanageable. In contrast, small agencies, which resolve problems through informal and informed advice from members of the industry, may be more efficient. In short, lack of uniformity does not justify full federal preemption of bank regulation.\textsuperscript{18}

C. Lax Standards

Those opposed to the dual banking system argue that it produces a “competition in laxity”\textsuperscript{19} or a “race to the bottom” because the system functions as a competitive market.\textsuperscript{20} The sellers are the regulators; the buyers are the consumers of regulation, be they bankers, depositors, or voters in general. These

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\textsuperscript{18} See, for example, the non-bank bank debacle, \textit{id.} at 695. Agencies fight over regulatory turfs and undermine each others’ decisions by countermanding each others’ permissions. \textit{See id.} at 696-97. Lack of uniformity persists at each level of government. In addition, since responsibilities are divided, some banks fall through the cracks and are not adequately supervised, while others are “over supervised.” Finally, frequent challenges by competing financial institutions produce unpredictability. \textit{Id.} at 676.

\textsuperscript{17} \textit{Id.} at 675-76, 682, 683.

\textsuperscript{18} Lack of uniformity can be reduced through cooperation and coordination, methods that are currently utilized by state regulatory agencies.


\textsuperscript{20} See, \textit{e.g.}, Fein, \textit{supra} note 3, at 697.
consumers are competing interest groups: depositors and voters versus charter seekers and charter holders (the banks); small banks versus big banks; and banks versus members of other financial industries.

The commodity sold in this market is regulation. State and federal governments "sell" their powers to govern, to tax, to limit and reduce banks' activities, or to impose costly reserve or capital requirements on banks. Governments "sell" to their constituent banks protection from competition from outside banks; greater powers and lower entry thresholds to expanding banks; protection from bank abuses; and protection from concentration of bank power to depositors, borrowers and voters. In consideration for these governmental actions, purchasers may vote for the governments, or bring jobs and capital into the states.

The concern that the system produces a race to the bottom is unjustified. Whether a government relaxes or tightens regulation depends on the government's priorities, who is "buying" the regulation, and what the "payment" is. These factors determine whether the regulation is strict (if the buyers are competitors or consumers) or lax (if the buyers are expanding banks). This is why competition has not driven states to reach the bottom, abolish all regulation and introduce "free banking."

Another reason, suggested by Professor Scott, is that a state that is relaxing regulation attracts more banks to its borders, producing at some point an overcrowding that renders the state less attractive as a business location. This reduces the pressure on the state to relax its rules. Thus, an equilibrium in the banking market is reached.

Another explanation is tied not to the market for banking,

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21 See id. at 13-23, describing the advantages to banks franchising under different governments. These advantages stem from the Constitution, implied powers of Congress to regulate banks, federal and state statutes, and administrative discretion. All these sources of regulation produce meaningful differences for regulated banks.

22 For example, the regulation of check clearance delays.

23 See Sudo, 9 States Pass Interstate Bills, 5 Still Considering Them, C.I. AM. BANKER 145, July 26, 1985, at 6. Some states prohibit competition from non-bank banks. Some states support regional interstate banking. Other states support the creation of national banking at a future date, or oppose all these measures. See also Kessler, Here Come the Regional Superbanks, 110 FORTUNE 137 (Dec. 10, 1984); Brechenfeld, Little Delaware's Powerful Lure for Big Banks, 107 FORTUNE 147 (Mar. 16, 1983).

24 Scott, supra note 9, at 33. See also note 27 infra.
but to the market for regulation. Competitive regulation is affected by the strength of particular special-interest groups within the state: a strong interest group seeks state protection; a weak interest group seeks a coalition with groups of similar interest in other states, and appeals for federal regulation. On the federal level, these weak interest groups can become a strong force.25

The dreaded race to the bottom does not materialize because at some point one interest group within the state is checked by another interest group in the state or by the federal government (mobilized by the weak interest groups in the states).26 Then, the state's standards solidify, as the various interests settle within their protective government's mantle. An equilibrium in the market for regulation is reached.

States also do not "hit the bottom" because of the courts. The courts play an important and interesting role in the market for bank regulation, reminiscent of the role of the specialists in the securities markets — providing liquidity and reducing price fluctuations. The courts act in such a way as to reduce extreme regulatory changes.

For example, in the 1960s the Supreme Court overruled the attempts of James J. Saxon, the Comptroller of the Currency to broaden the powers of national banks to deal in securities. Saxon did not command a following among other agencies or in Congress or the states. He tried to introduce extreme changes,

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25 Noam, The Interaction of Federal Deregulation and State Regulation, 9 Hofstra L. Rev. 195 (1980); Noam, Government Regulation of Business in a Federal State: Allocation of Power under Deregulation, 20 Osgoode Hall L.J. 762 (1982). It is interesting that the agencies that advocate unitary and concentrated regulation at the federal level are agencies of the executive branch. See, e.g., Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services, July 2, 1984 (George Bush, Chairman). This fact supports Professor Noam's thesis. Both the Federal Reserve Board and the Office of the Comptroller are less affected by interest groups.

26 For example, a government's interest in protecting depositors or the integrity of the monetary system may be superseded by its interest in attracting banks to its jurisdiction. This may occur when the government's regulation has become so onerous as to cause a mass exodus of banks from its territory. Even if, at this point, another state (with a lower stake in protecting depositors) continues to relax its standards of regulation, banks will not instantly relocate because the relocation process is costly in time and money. In addition, when a sufficient number of banks have relocated into the hospitable state, that state's interests in raising the standards may be sufficiently high (having been raised by the pressure of other interest groups to do so) to maintain or increase its level of regulation.
and his activities would have caused severe disruptions in the market for bank regulation. Hence, the Supreme Court struck down his innovations. Twenty-four years later the situation has changed. Although no consensus has formed on the federal level, the movement to grant banks some power to engage in securities transactions has found support in a number of states and in the market place. This time the Supreme Court has taken a different attitude. On the same day, in June 1984, the Court handed down two decisions, one for and one against securities activities by banks. Thus, the Court has acted to dampen extreme regulatory changes.

Even if the dual system produces too much or too little regulation, there is nothing to support the contention that a unitary centralized agency regulating banks will not suffer from the same malaise. Concentrated government and private power is as likely to produce “too much” or “too little” regulation. Mistakes will be worse, however, for under such a system their impact will be national rather than local.

In sum, although some standards may be proven too lax or too strict, fluctuations of legal standards are not necessarily harmful. A dual system provides a process by which if one government “goes strict,” another government could “go lax,” and vice versa, until an equilibrium level of regulation results.

We do not know whether the particular South Dakota law is “too lax.” The dual system allows us to discover the answer at reduced risk to the national system. If the experiment adversely affects the financial system, the affected states will exert pressure and Congress may abort the experiment; or, South Dakota may do so voluntarily. Only if the experiment is permitted, however, will we know the answer.

D. The Dual System Has an Anti-Competitive Effect

Critics argue that the dual system has anti-competitive effects since it produces state protective regulation of banks and a different set of regulations for financial intermediaries that es-

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28 See Securities Indus. Ass'n v. Board of Governors, 468 U.S. 137 (1984); Securities Indus. Ass'n v. Board of Governors, 468 U.S. 207 (1984). The Court also preferred that the securities activities be conducted in bank holding company subsidiaries rather than in the bank itself, as proposed to Congress by the Treasury Department.
sentially provide the same services. These differences create competitive inequalities and unfair discrimination among various species of financial institutions\(^9\) and among members of the same industry.\(^{30}\) The critics argue that the system curtails market efficiencies and cramps the industry innovations that usually accompany market competition.\(^{31}\)

One answer to this criticism is that it is not dual regulation but the substance of particular regulations that has an anti-competitive effect. Congress has passed protective legislation on subjects within its exclusive jurisdiction. Second, if the dual system reduces the intrusion of regulation on business, competition among industry members may increase. Third, it is arguable that competition among the states may actually guard against the special protection that a single regulatory agency might produce.\(^{32}\)

In addition, it is unclear whether unfettered competition among financial institutions is desirable. In the 1930s the government concluded that the importance of stability in the banking system outweighed the benefits of competition among banks. Fifty years later, the winds are blowing in the opposite direction, but there is still no consensus as to the optimal competitive pressure on banks, or how to control bank competition with the least governmental intervention.

III. ALLOCATION OF GOVERNMENTAL POWERS TO THE “BEST REGULATORS”

For the foregoing reasons I conclude that the dual banking system is better than a unitary federal regulatory system. This conclusion, however, does not help to guide Congress as to when to preempt state regulation. I suggest that Congress adopt a test

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\(^9\) One can demonstrate that Congress is attempting to achieve a “level playing field” among different financial institutions. See for example, the Garn St. Germain Depository Institutions Act of 1982, which attempts to give banks the competitive equivalent of money market funds. 12 U.S.C. § 1730a(m) (1982).

\(^{30}\) For example, see Fein, supra note 3, at 675, 681. National banks are examined by, and apply for branch permission to only one agency, the Office of the Comptroller, whereas state chartered banks are examined by both state and federal examiners. Id. at 681. If dissatisfied, state banks can convert into national banks, although “conversion” is not cost free.

\(^{31}\) See, e.g., Fein, supra note 3, at 675.

\(^{32}\) See Scott, supra note 9, at 48.
for determining who is the "best regulator" with regard to a particular subject matter. In the sections that follow, I propose criteria for making this determination and test South Dakota's qualifications as the "best regulator."

A. Defining the "Best Regulator" by Efficiency Standards

Economic theory suggests that tasks should be assigned to those who are able to perform the tasks most efficiently. Economists may say that one regulatory system is more efficient than another if it produces more "units of regulation" of similar quality, using the same amount of resources. Since lower costs can result from expertise and experience, experts are "better" regulators. For example, states would probably control local banks better than they would regulate the country's money supply.53

South Dakota has the expertise to regulate bank powers. Like all states, it has traditionally regulated not only the insurance business, but also the powers of its chartered banks (with the exception of securities activities regulated by the Glass-Steagall Act). Therefore, South Dakota has experience and expertise to offer bank charters.

However, the choice of a regulator should not be based on experience alone. Experience may become a barrier to change. Moreover, governments acquire expertise simply by allocating adequate resources. Thus, if a state gives low priority to some regulatory functions, it will not acquire the necessary expertise, and its past experience will not make up for its deficiency in expertise.

In addition, the cost criterion of the economic "best regulator" model is flawed because it is not always possible to measure the adequacy of quantity or quality of regulation by cost alone. The criterion merely asserts that, given a particular regulation, the best regulator is the one who performs at the lower cost. But cost does not tell us whether the regulators are best qualified to determine if and how to regulate.

B. Defining the "Best Regulator" by Self-Interest

A more useful criterion for defining the "best regulator" is

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53 See Fein, supra note 3, (citing Senate Comm. on Gov't Affairs, 95th Cong., 1st Sess., Study on Federal Regulation Vol. V, at 4-13 (Comm. Print 1977)).
self-interest. The best governmental entity for a particular regulation is that which reaps the benefits and bears the consequences of its regulatory activities. The term “benefits” includes not only the “payment” that the state receives for the regulation but also the benefits that the state reaps from the effect of the regulations. “Consequences” includes all costs generated by the regulatory actions, including enforcement costs and risks. When fully internalized, so that the net results inure to the regulating government, both the benefits and the adverse consequences discipline the government to produce the “optimal” amount of regulation. This criterion also satisfies the need to accommodate the different purposes of the various states, since each state will establish the best regulation for itself.\textsuperscript{34}

The criterion as proposed above is absolute. But suppose that the regulating government does not completely internalize the benefits and costs, and that the adverse effects of its actions spill over and touch other states, or the federal insurance corporation, or the entire financial system. Arguably, every state’s action impacts on the entire country. Such impact occurs even without the intent of the acting state if the state is unable to take responsibility for its actions. For example, when Ohio and Maryland permitted their savings and loan associations to operate under a lax system, the consequences of the depositors’ runs on these associations endangered the national financial system and burdened the federal insurance fund.\textsuperscript{35} Moreover, some commentators argue that banking is primarily a federal matter,\textsuperscript{36} that the states tend to inhibit an efficient national economy,\textsuperscript{37} and that states undermine the legitimate policies of the federal government, such as policies regarding the money supply.\textsuperscript{38}

\footnotesize{\textsuperscript{34} Different states with different interests are not affected by the same laws in the same way. To the extent that self-regulation is based on different self-interest, the regulatory system imposed by one state is not appropriate for another state.}

\footnotesize{\textsuperscript{35} In fact, the dollar declined on the international markets as a result of these problems.}

\footnotesize{\textsuperscript{36} See, e.g., Fein, supra note 3, at 711.}

\footnotesize{\textsuperscript{37} See, e.g., Clarke, The Futility of Current Approaches to Bank Regulation, 4 J.L. & COMM. 213, 271 (1984).}

\footnotesize{\textsuperscript{38} See, e.g., Fein, supra note 3, at 680-81. As proof, commentators point to the recent preemption of state laws and regulations to accommodate national needs. See Scott, supra note 9, at 5-6. See also Glidden, supra note 11, at 371-73 (federal agencies currently have most of the regulatory powers over banking with the exception of branching and interstate banking; even those latter powers are being eroded).}
If these arguments are valid, then the proposed criterion is useless. However, these arguments lead back to the underlying issue — the validity of the dual system. If we prefer the dual system, then we must also accept some effect of states’ actions on other states and on the federal system. Therefore, the issue becomes one of line drawing. At what point does a state cease to be the “best regulator” because it has ceased to bear the major portion of the consequences of its actions? To answer this question, a further inquiry into the reasons for the proposed criterion is necessary.

There are two main reasons for the “self-interest” criterion. First, those who bear the responsibility for their actions are best suited to gauge the ratio of adverse and beneficial consequences. Assuming a positive correlation between the benefits and the adverse effects of a state’s statute, when the benefits are internalized and the costs are externalized, the state will have little incentive to reduce the costs, especially if this reduction is accompanied by a reduction of benefits. Therefore, the criterion of internalizing consequences acts on the regulating state as a disciplinary mechanism. However, if a state’s regulation substantially harms a large number of states, and in fact involves the federal system, federal preemption is in order. Our criterion should therefore be refined to state that federal regulators are the “best” when there is a high probability that state regulation will adversely affect the national financial system, rather than the interests of that state.

A related reason for the self-interest criterion is based on a balanced autonomy among the states. In a participatory federal system, states should be able to enact regulation even if it affects other states. Each state should have the right to protect itself from harmful regulations of another state within constitutional limits. Therefore, each state may pass regulation even though it imposes the costs of its regulation on other states, but the latter should be able to protect themselves within constitutional limits. Under this reasoning, a state should not be allowed

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29 So long as interstate banking was prohibited, the effect of one state's regulation on other states was minimal. With the expansion of interstate banking and regional banking the adverse effects of low standards of regulation or of bank competition with other non-bank financial services has increased. If this grows, so will competition among states. If states form cooperative groups, such as regional arrangements, competition may abate.
to benefit from its regulation at the expense of other states, unless those other states can prevent the harm to them. When such protection is legally possible, every state should be allowed to enact regulations that affect others.

This reasoning seems to contradict the rationale based on the disciplinary effects of internalization of adverse effects. The ability of other states to protect themselves from harmful regulation should be irrelevant, because self-protection by other states does not provide the discipline of internalizing adverse consequences. If that discipline is missing, a regulating state will continue to increase its benefits at the expense of other states, and impose on other states the increasing costs of preventing the harm.

The answer to the puzzle is that in many situations self protection by other states results in disciplining the regulating state, although in a different manner than by internalizing adverse consequences. Self-protection by other states reduces the benefits that the regulating state can offer in its charters. In the case of South Dakota, for example, any state that precludes the sale of insurance policies issued by South Dakota banks reduces the value of the South Dakota charters, and the benefits that it will reap from these charters. If most states take such steps, the value of South Dakota charters will be reduced substantially. By increasing the costs to other states, South Dakota will not obtain higher benefits for itself. Thus, whereas the internalized costs limit the incentives of the regulating state to incur such costs, the ability of other states to reduce the benefits attendant to costs also reduces the incentives to increase costs.

Therefore, the proposed criterion should be further refined to add that even when a state does not bear the consequences of its regulation, as long as other states can protect themselves against these consequences in a way that would reduce the benefits to the regulating state, federal law should not preempt these regulations.

If constitutional constraints prevent states from protecting themselves from the adverse effect of another state’s regulation, two viable approaches exist. First, federal preemption may be justified because the regulating state is free of disciplinary constraints. An alternative approach would permit states to regulate, even when they harm other states, and even if those states have no recourse to self-help. Congress is not precluded from
preempting state law in this case. However, Congress would not act on the basis of principle, but on the basis of political considerations: special interest groups injured by other states' regulation may create a coalition and successfully lobby for congressional action.

I opt for the second approach. If the harm to interest groups outside the regulating state cannot be redressed because of constitutional limitations, let them resort to political muscle. The regulating state may find itself sooner or later overruled by Congress through the political process, but in principle, Congress should permit state regulation even in these circumstances.

The final form of the proposed test is, therefore, as follows:

1. A state is the "best regulator" if the state reaps the benefits and bears the consequences of its regulation.

2. Substantial self-benefits and costs are sufficient to satisfy the test. However, if the difference between the benefits that a state reaps from its regulation, and the adverse effects that these regulations impose on other states are substantial, the state's qualification as the "best regulator" is reduced.

3. If other states can protect themselves from the adverse effects of the regulation, the regulating state may remain the "best regulator," provided the other states' protections reduce the value of the benefits that the regulating state obtains, for example, by reducing the value of the state's charters.

4. Even if affected states cannot protect their constituencies from the adverse effects of another state's regulation (for example, because of constitutional constraints), the state may still be the "best regulator" if the interests of the harmed constituencies are amenable to political protection. In such a case, Congress can preempt this state legislation, but only on political grounds and not on policy grounds.

5. Whenever, in the opinion of Congress, a state's regulation directly affects the national interest, the state's laws should be preempted.

C. The South Dakota Case

Applying these criteria to South Dakota, we should examine the groups affected by the grant of the South Dakota charters. The first group are the consumers of insurance offered by South Dakota banks. These policy buyers are not necessarily South Dakota residents. To this extent South Dakota is not subject to
the discipline of internalized costs. However, the home states of the policy buyers can take non-discriminatory measures to protect them, for example, by requiring the sale of insurance to be backed by deposits within the state. These protections reduce the possible adverse effects on out-of-state residents and increase the regulatory costs of the South Dakota bank, which, in turn, reduce the value of South Dakota charters. In short, other states can indirectly discipline South Dakota chartering activities.

The second group affected by the South Dakota law are the insurance agents and insurance companies with whom South Dakota banks compete. As a matter of policy, there is no reason why these insurance agents and insurance companies should be protected from additional competition. In fact, home states are constitutionally prohibited from shielding domestic businesses from out-of-state competition (except to the extent that home states may provide non-discriminatory protection). As long as the banks’ competition does not lead to the demise of these industries, there is no reason to prohibit banks from exercising these powers.

A third group affected by the statute are the bank’s shareholders. To the extent that these shareholders are not South Dakota residents, other states’ residents are affected. Yet shareholders can react to the South Dakota charter through the securities markets for the shares of the holding company of any bank that sells insurance. In addition, state blue-sky-law regulators and the Securities and Exchange Commission could use their regulatory powers to protect these shareholders. These actions can reduce the adverse effect of South Dakota’s statute on other states. Furthermore, to the extent that they reduce the value of South Dakota charters, these shareholders and agencies can indirectly discipline South Dakota.

The fourth group affected by South Dakota’s statute are the banks’ depositors. To the extent that the insurance activities of the state chartered banks endanger the safety of the deposits of the state’s citizens, and its businesses bear the brunt of the bank’s losses, South Dakota remains the “best regulator” since it is self-interested. However, if the bank’s deposits are insured by the Federal Depository Insurance Corporation (FDIC), then, this federal insurance fund is also directly affected by any South Dakota bank failure. In such a case, the FDIC has a legitimate in-
terest jointly with South Dakota. Its concerns should be ac-
corded great weight and, if sufficiently serious, should cause the
termination of the South Dakota experiment.

In sum, the South Dakota legislation is subject to substan-
tial constraints on the possibility of benefiting at the expense of
other states. Therefore, South Dakota should be permitted to
conduct its experiment. Although empirical data may not be
available, insurance powers should not endanger the financial
stability of a bank, provided the bank is carefully regulated. In-
urance powers should, in fact, strengthen a bank's financial
condition by diversification. This conclusion is subject to rebut-
ting evidence showing that the experiment poses a substantial
threat to the safety and soundness of the financial system. Until
such a showing is made, I submit that the South Dakota experi-
ment should be allowed to proceed.

CONCLUSION

The South Dakota case demonstrates the conflict between
the principled policy that I advocate and the possible political
pressures on Congress. If Congress or the federal agencies over-
rule the South Dakota statute, the underlying reasons, except
for positive law, seem to be political. There is little justification
for protecting insurance companies and insurance agents from
bank competition, or any competition. Unless there is evidence
that the statute endangers the safety of the national financial
system, the South Dakota experiment should be allowed to
proceed.