

RECOMMENDATIONS FOR REORGANIZING THE U.S. FINANCIAL REGULATORY STRUCTURE



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COMMITTEE ON CAPITAL MARKETS REGULATION



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The U.S. financial crisis has put the issue of financial regulatory structure on the front burner of public policy for the first time in decades, making possible reforms on a scale not imaginable since the Great Depression. Indeed, the severity of the crisis, the scope of the regulatory failures and the antiquated, patchwork design of the U.S. regulatory structure have given rise to a broad consensus regarding the need for sweeping regulatory reorganization.

This consensus presents a historic opportunity to bring U.S. financial regulatory structure into the 21st century, ensuring our role as a global leader in financial markets. Done properly, reform will restore market confidence, increase consumer and investor protection, improve regulatory quality, stimulate capital formation, enhance our ability to manage systemic risk and facilitate global policy coordination.

The Committee on Capital Markets Regulations believes there is enormous room to improve our regulatory structure. The U.S. employs more financial regulators and expends a higher percentage of its gross domestic product on financial oversight than any other major country. There are approximately 38,700 financial regulatory staff in the U.S., versus some 3,100 in the United Kingdom.[\[1\]](#) Meanwhile, financial regulatory costs in the U.S. total \$497,984 per billion dollars of GDP, versus \$276,655 in the United Kingdom.[\[2\]](#)

Yet recent events suggest that the far larger staffs and greater funding in the U.S. have not resulted in a correspondingly higher quality of supervision. The U.S. Treasury recognizes this, and issued its own bold recommendations, “Blueprint for a Modernized Financial Regulatory Structure,” in March 2008.

At its core, federal financial regulation performs four functions: providing a lender of last resort, supervising and regulating financial institutions for safety and soundness, regulating market structure and conduct and providing for consumer/investor protection. Any regulatory structure must effectively perform these four functions. Further, the Committee believes that the functions must be coordinated by the President through the office of the Secretary of the Treasury. However, determining which part of the regulatory structure performs some or all of these functions is a more difficult challenge.

The Committee’s recommendations address only revisions to U.S. federal regulatory structure. The Committee may consider later whether to address the role of the states and self-regulating organizations (“SROs”), internal agency organization, or global coordination.[\[3\]](#)

The Committee is a non-partisan group of independent U.S. business, financial, investor and corporate governance, legal, accounting and academic leaders. It was formed in the fall of 2006 to study and report on ways to improve the regulation of U.S. capital markets.

Summary of Recommendations

1. The U.S. should have only two, or at most, three independent regulatory bodies overseeing the financial system: the Federal Reserve Bank (“Fed”), a newly-created independent United States Financial Services Authority (“USFSA”) and possibly another new independent investor/consumer protection agency.
2. The Fed would retain its exclusive control of monetary policy and its lender-of-last-resort function, as part of its key role in ensuring financial stability. In addition, because of its institutional expertise, its significant role in the Basel process and the demonstrated relation of capital requirements to financial stability, the Fed would set capital requirements for all financial institutions.
3. The USFSA would regulate all aspects of the financial system, including market structure and activities and safety and soundness for all financial institutions (and possibly consumer/investor protection with respect to financial products if this responsibility were lodged with the USFSA). It would be comprised of all or part of the various existing regulatory agencies, such as the Office of the Comptroller of the Currency (“OCC”), the Office of Thrift Supervision (“OTS”), the Federal Deposit Insurance Corporation (“FDIC”), the Securities & Exchange Commission (“SEC”) and the Commodities Futures Trading Commission (“CFTC”). The possible divisions of responsibility between the Fed and USFSA with respect to supervision for safety and soundness are discussed below.[\[4\]](#)
4. The Treasury would coordinate the work of the Fed and USFSA. The Treasury would also be responsible for the expenditure of public funds used to provide support to the financial sector, as in the Troubled Asset Relief Program (“TARP”). In addition, to preserve the independence and credibility of the Fed, existing Fed lending against no or inadequate collateral would be transferred to the Treasury, and future lending of this type would be done only by the Treasury. All such lending would be on the federal budget.
5. There are three options with respect to the supervision of financial institutions: (1) the Fed supervises all financial institutions determined to be “systemically important” and the USFSA supervises all other institutions; (2) the Fed supervises all financial institutions; or (3) the USFSA supervises all financial institutions. While we agree there are tremendous advantages to consolidated supervision, we do not endorse any of the three options. Instead, we present the advantages and disadvantages of each.
6. A vigorous consumer/investor protection body with respect to financial products could exist either as a division within the USFSA or as a self-standing third independent agency. If part of the USFSA, Senate confirmation of the division/agency head would help ensure strong Congressional oversight and rigorous enforcement. The Committee did not reach consensus on which of these two alternatives would be preferable.

Aspects of Regulatory Structure Upon Which The Committee Reached Consensus

- Two or Three Regulatory Bodies: The U.S. should have only two or, at most, three independent federal regulatory bodies overseeing the U.S. financial system—the Federal Reserve Bank (“Fed”), a newly-created independent United States Financial Services Authority (“USFSA”) and possibly an independent investor/consumer protection agency. This means that various existing regulatory agencies, such as the Office of the Comptroller of the Currency (“OCC”), the Office of Thrift Supervision (“OTS”), the Federal Deposit Insurance Corporation (“FDIC”), the Securities & Exchange Commission (“SEC”) and the Commodities Futures Trading Commission (“CFTC”) would all be merged and consolidated into these two or three bodies. The United States occupies a distinct place in the world, and any decision regarding U.S. regulatory structure must be uniquely tailored to the needs of the United States. However, it bears noting that the vast majority of other leading financial center countries have moved towards more consolidated financial oversight. As shown in the accompanying paper by Professor Howell Jackson of Harvard Law School, “A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States,”^[5] the overwhelming trend is towards a more consolidated regulatory structure, whether of the three regulator model employed in Australia and the Netherlands (where, in addition to the central bank, one regulator is responsible for prudential regulation, while a second regulator focuses on business conduct in the financial sector) or the more consolidated model employed in Japan and the United Kingdom (where there is a single regulator in addition to the central bank). A rapidly dwindling share of the world’s financial markets are supervised under the fragmented, sectoral model still employed by the United States.

Below are the relative responsibilities we believe appropriate for the regulatory bodies in a system of consolidated oversight.

- Responsibilities of the Fed: The Fed would retain its exclusive control of monetary policy and its lender-of-last-resort function as part of its key role in ensuring financial stability. In addition, because of its institutional expertise, its significant role in the Basel process and the demonstrated relation of capital requirements to financial stability, the Fed would set capital requirements for all financial institutions. Fed control of capital requirements for all institutions would ensure consistency across financial institutions, enable rapid reform and avoid the adverse competitive consequences of different agencies setting different capital standards for essentially the same activity.
- Responsibilities of the USFSA: The USFSA would regulate all aspects of the financial system, including market structure and activities and safety and soundness for all financial institutions (and possibly consumer/investor protection with respect to financial products if this responsibility were lodged with the USFSA). Again, there is a need for consistency, rapid reform and avoidance of adverse competitive consequences in all financial institution regulation. This can only be ensured if regulation is undertaken by one agency. Moreover, that agency must be independent, like the Fed,

such that its regulations are subject only to judicial—not executive—review and the appointment of its governing body and membership, again like the Fed, is insulated from the electoral cycle. The possible divisions of responsibility between the Fed and USFSA with respect to supervision for safety and soundness are discussed below.

- Responsibilities of an Independent Investor/Consumer Protection Agency or Division of the USFSA: Whether this activity is organized in a separate agency or as a division of the USFSA is discussed at the end of this document; no consensus on this matter was reached by the Committee. We do note, however, that the relevant prudential supervisor should give its input to the investor/consumer protection body regarding the safety and soundness impact of its regulatory actions; any conflict between the supervisory and investor/consumer protection body should be resolved by the Treasury. Moreover, if investor/consumer protection is undertaken in a division of the USFSA, the head of the agency should be Senate-confirmed to ensure strong congressional oversight and rigorous enforcement by the division.
- Role of the Treasury: The Treasury would coordinate the work of the regulatory bodies. The difficulties experienced by the UK’s Tripartite Committee (FSA, Bank of England and HM Treasury) in connection with the failure and bailout of Northern Rock highlight the importance of communication and coordination between regulators. The U.S. Treasury must ensure that there are written procedures, perhaps in the form of memoranda of understanding, setting forth the exact responsibilities of the regulatory bodies.

The Treasury should also be responsible for the expenditure of public funds used to provide support to the financial sector, as in the Troubled Asset Relief Program (“TARP”). Specifically, Section 101 of the Emergency Economic Stabilization Act of 2008 (“EESA”) authorized the Treasury Secretary “to purchase, and to make and fund commitments to purchase troubled assets,” creating an Office of Financial Stability within the Treasury to administer the program.

In addition, any existing Fed loans to the private sector which are uncollateralized or insufficiently collateralized should be transferred in an orderly fashion to the balance sheet of the federal government (through asset purchases by the Treasury from the Fed). Any losses of the Fed are ultimately losses for U.S. taxpayers and should be directly and transparently accounted for as part of the federal budget. For the same reason, going forward, only the Treasury should engage in insufficiently collateralized lending. As argued in the accompanying paper by Professor Kenneth Kuttner at Williams College—“[The Federal Reserve as Lender of Last Resort during the Panic of 2008](#)”^[6]—the Fed’s assumption of credit risk by lending against insufficient collateral may compromise its independence by: (1) making the Fed more dependent on the Treasury for support in carrying out its core functions, including the conduct of monetary policy (see the supplemental finance facility under which the Treasury supplied additional Treasury bills to the Fed); (2) jeopardizing the ability of the Fed to finance its own operations and thus the need to look for budgetary support from the government; (3) tarnishing its image and financial credibility in the event that the Fed ends up with minimal or negative capital; and

(4) making it more subject to political pressures. Shifting risk to the Treasury from the Fed has already begun with the Treasury's use of the TARP to both purchase \$40 billion in preferred AIG shares (allowing the Fed to reduce its line of credit to AIG) and absorb the first \$20 billion in losses associated with the Fed's new Term Asset-Backed Securities Loan Facility ("TALF") created to purchase newly issued asset-backed paper.

- Phased Transition over Time: The accompanying paper by Professor Jackson argues, and we agree, that the U.S. should draw on the experiences of leading jurisdictions in devising a step-by-step consolidation process. Key steps are: (1) immediate enhancement of the President's Working Group on Financial Markets to play a coordinating role within the present federal regulatory structure; (2) prompt enactment of legislation creating an independent USFSA (and possibly an independent consumer/investor protection agency); and (3) a second round of legislation authorizing the merger into the USFSA (and possibly the independent consumer/investor protection enforcement agency) of all other federal supervisory agencies. While the merger of the SEC and CFTC contemplated in the medium term by the Treasury's Blueprint could be a transitional step, it should not be an end in itself; full consolidation within the USFSA (or independent consumer/investor protection enforcement agency) should be the ultimate outcome. In addition, a plan should be immediately formulated for the orderly shift of risky assets from the Fed to the Treasury. The completion of this entire process could well take several years.
- Supervision of Financial Institutions

Aspects of Regulatory Structure Upon Which The Committee Did Not Reach Consensus

As a background matter, we believe there are tremendous advantages to consolidated prudential supervision. Such an approach, as implemented in leading jurisdictions around the world, offers significant advantages over the current model of overlapping or fragmented supervision. While regulatory failures of the past decade can be traced to many causes, the fragmented U.S. system of prudential supervision narrowed the field of vision of every regulatory body and dissipated supervisory resources through contests over jurisdictional boundaries. Such a system also impairs our ability to coordinate supervision internationally. Some have criticized the SEC with respect to its supervision of investment banks, such as Bear Stearns and Lehman Brothers, and broker-dealers, such as Madoff. We believe supervision should be undertaken by agencies with sufficient resources and expertise, *i.e.*, either the newly created USFSA or the Fed.

Consolidated prudential supervision can: (1) ensure the implementation of consistent regulatory requirements across different sectors, drawing from best practices and past experiences in all sectors; (2) enhance the capacity to attract and retain high quality staff and to reassign those staff promptly as needed across different sectors of the industry; (3) diminish the risk of regulatory capture; and (4) enhance accountability.

Below we present three options for supervising financial institutions, as well as the advantages and disadvantages of each.

- Option 1: Fed Supervision of Financial Institutions Determined to be “Systemically Important” and USFSA Supervision of All Other Institutions
- *Advantages:* By virtue of its existing supervision of bank holding companies and state-chartered banks that are members of the Federal Reserve, combined with the knowledge obtained from its open market operations, lender-of-last-resort function, and oversight and operation of payments and settlement systems, the Fed possesses a deep understanding of the issues confronting financial institutions. Further, the quality of examination is arguably higher today at the Fed (due to culture and salary levels) than in other regulatory agencies, and arguably would remain higher than in a new USFSA. Finally, since the Fed may be called upon to lend to financial institutions, either as a matter of course through the discount window, or in a crisis, the Fed needs detailed knowledge of financial institution operations and risks. And to avoid moral hazard, the Fed needs the power of corrective action through supervision, to control the risks to financial institutions and ultimately to itself.

The Fed would focus on only those institutions determined to be “systemically important.” This would arguably optimize its institutional competence and permit it to focus on institutions that it may have to lend to on a significant scale. At the same time, the USFSA would supervise those institutions determined not to be “systemically important.” Either the Treasury alone, the Fed alone, or the Fed and Treasury jointly could determine which institutions are “systemically important.”[\[7\]](#)

- *Disadvantages:* It would be difficult to determine *ex ante* and over time which institutions are “systemically important.” Further, designating any institution as “systemically important” may create a moral hazard because the market will interpret any such institution as “too big too fail”; the consequence could be stratification of the industry, with significant cost-of-capital implications. Conversely, being regarded as non-systemically important might remit an institution to second class status. While it is relatively clear who these institutions are even absent formal designation, this approach would codify the distinction and remove all ambiguity. Finally, Fed supervisory jurisdiction over systemically important institutions risks distracting the Fed from its core mission of conducting monetary policy and potentially exposes it to political pressures, though it may already be exposed to such pressures with respect to its current supervision of state member banks and bank holding companies.

- Option 2: Fed Supervision of All Financial Institutions[\[8\]](#)
- *Advantages:* Fed supervision of all financial institutions has many of the same benefits of Fed supervision of systemically important institutions—chiefly, the Fed’s unique institutional competence.
- *Disadvantages:* An expansion of its supervisory jurisdiction—particularly with respect to relatively small institutions—risks distracting the Fed from its core mission of

conducting monetary policy and dealing with systemic risk; it also risks excessive concentration of power in one agency. Further, risk to the Fed from its lending operations is likely to be significant only in the case of “systemically important” institutions. In addition, a new USFSA could achieve the same quality of examination as is provided by the Fed today for most institutions. Finally, such a broad supervisory role risks subjecting the Fed to political pressures, as discussed above.

- Option 3: USFSA Supervision of All Financial Institutions

- *Advantages:* The Fed would be free to focus on its core mission of conducting monetary policy while the USFSA could enjoy supervisory economies of scale and could achieve consistency. This would not mean that the USFSA would supervise all institutions in the same way. As with the U.K. FSA, supervision of a financial institution would depend on its level of risk and the nature of the activities. The Fed could arguably rely on the supervision of (and get needed information from) this new agency if it achieved the same quality in its supervision as the Fed presently provides. Putting regulation through rule-making and supervision in one agency makes sense because these two regulatory techniques complement each other.

- *Disadvantages:* The USFSA might not give the “systemically important” institutions the same attention or priority as would the Fed. Moreover, such an arrangement might deprive the Fed of direct and real-time information necessary to make lender-of-last-resort decisions, since its information would have to come from the USFSA.

- Location of Consumer/Investor Protection: We believe a vigorous consumer/investor protection body could exist either as a division within the USFSA or as a self-standing agency. If part of the USFSA, Senate confirmation of the division/agency head would help ensure strong Congressional oversight and rigorous enforcement. The Committee was unable to reach consensus on which of these two alternatives would be preferable.

- Locating the Consumer/Investor Protection Division Within the USFSA

- *Advantages:* It would be difficult to separate issues of investor/consumer protection from other regulatory objectives such as safety and soundness and market structure and conduct. Putting these matters in one agency avoids such line drawing problems. Full integration would also facilitate tradeoffs between competing policy interests pursued by the USFSA. Moreover, the division could benefit from the institutional expertise of an agency with a necessarily broader focus. While a separate agency could be charged with making such trade-offs, it is much less likely that it would do so in practice.

- *Disadvantages:* Trade-offs may be undesirable if they would undermine strong consumer/investor protection.

- Creating a Separate Consumer/Investor Protection Agency

- *Advantages:* Ensures a single-mission focus on consumer/investor protection.

- *Disadvantages:* Such an agency would not effectively weigh competing policy interests. In addition, it will be difficult to coordinate the inevitable conflicts between prudential regulation and consumer/investor protection.

* One of our members, Robert Pozen, did not take part in the decision to issue this statement.

[1] See Howell E. Jackson, Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications, 24 Yale J. Regulation 253, 268 (2007).

[2] *Id.*

[3] In March, the Committee will release a new report—“Capital Markets Regulation After the Credit Crisis”—addressing key substantive regulatory issues.

[4] We define “supervision” to mean the examination of financial institutions for safety and soundness, as opposed to “regulation”—the promulgation of generally applicable rules. “Financial institution” may be defined broadly, as in Section 101 of the EESA, to “include any bank, savings association, credit union, security broker or dealer, or insurance company.”

[5] Available at www.capmksreg.org.

[6] Available at http://capmksreg.org/wp-content/uploads/2015/04/Kuttner_The-Federal-Reserve-as-Lender-of-Last-Resort-during-the-Panic-of-2008.pdf. Kuttner is a former Fed economist.

[7] We do not believe that supervision of holding companies should be split from supervision of financial institution subsidiaries. The same agency that supervises the holding company should also supervise the subsidiaries. The determination of “systemically important” should be made on the basis of the fully consolidated holding company.

[8] One variant of this option would be the Fed’s use of a two-tiered supervisory system for systemically important and other institutions. Such an arrangement, however, presents the moral hazard of effectively designating an institution as too big to fail.

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