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A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States

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A Pragmatic Approach to the Phased Consolidation

of Financial Regulation in the United States

by

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Discussion Draft of October 23, 2008

Executive Summary

I. The authority of the Federal Reserve Board to oversee financial market stability should be expanded to cover all sources of systemic risk in the financial services industry, should be structured to coordinate effectively with other supervisory agencies, and should be designed to allow for consistent, appropriate forms of intervention in response to systemic risks.

II. Even after the authority of the Federal Reserve Board has been expanded, the consolidation of other federal financial regulatory functions should proceed; the experience of other leading jurisdictions indicates that consolidated supervision offer numerous benefits in terms of the quality and completeness of financial regulation and that the principal objections to consolidated supervision can be met through statutory safeguards and institutional design.

III: Experience in other leading jurisdictions also demonstrates that many of the benefits of consolidated oversight can be achieved without the statutory consolidation of front-line supervisory units and the world's premiere consolidated agency, the British FSA, was established in a multi-stage process whereby the enactment and implementation of new substantive statutes did not occur until the FSA has been in operations for several years.

IV. Drawing on these experiences, U.S. regulatory consolidation should follow a four-stage process: 1) immediate enhancement of the President's Working Group on Financial Markets; 2) prompt enactment of legislation creating an independent United States Financial Services Authority ("USFSA" or "Authority") to provide industry-wide oversight, coordinate existing regulatory structures, and lay the groundwork for combination of existing supervisory agencies; 3) a second round of legislation authorizing the merger into the USFSA all other federal supervisory agencies; and 4) resolution of the organizational structure of the Authority should be postponed until regulatory consolidation is complete.

V. This four-phase approach to regulatory consolidation improves the likelihood of successful transition by delaying controversial decisions, avoiding unnecessary steps, and providing an organizational structure that can lead reform while safeguarding continuity of supervision.

VI. The creation of a United States Financial Services Authority is also consistent with expansion of the Federal Reserve Board's role in overseeing market stability and would actually improve the capacity of the Board to perform that function effectively.

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The financial crises of the past year have put the issue of financial regulatory structure on the front burner of public policy for the first time in many years, making possible reforms on a scale not imaginable since the Great Depression. Dramatic increases in market volatility, unprecedented interventions by the Federal Reserve Board to sustain securities firms, palpable failures to protect consumers in mortgage lending markets, and lingering concerns over the competitiveness of the American financial services industry have all combined to put regulatory reorganization on the national agenda. While the United States employs more financial regulators and expends a higher percentage of its gross domestic product on financial oversight than any other major country,[1] events of the past few years suggest that the country has not obtained a higher quality of supervision than other jurisdictions. Indeed, to the extent the current credit turmoil had its origins in the United States, one could quite plausibly claim that our regulatory structure has done a good deal worse than other more streamlined systems in protecting consumers and ensuring market stability. As the rest of the world has moved towards more consolidated forms of regulatory oversight, a natural question posed by recent events is whether the United States should also undertake such a regulatory reorganization and, if so, how such a reorganization should be accomplished.

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

While recent events have brought issues of regulatory consolidation to center stage, the current crisis has also generated its own imperatives, most notably preventing any more systemic shocks to financial markets and restoring normal levels of credit provision. On these issues, the Federal Reserve Board, as the lender of last resort in U.S. capital markets, is a critical player, and many short-term initiatives quite reasonably entail the expansion of Federal Reserve Board authority. In some cases, such as the creation of the new credit and liquidity facilities of the past few months, the Board itself has expanded its supervisory reach under existing statutory powers. In other cases, such as the recent memorandum of understanding between the Federal Reserve Board and the SEC, the expansion has been effected through improved information sharing agreements with other regulatory bodies. And, in yet other cases, such as recent legislative proposals coming in congressional testimony from Treasury Secretary Paulson and Federal Reserve Board Chairman Bernanke, the expansion of Federal Reserve authority would necessitate legislative action. But a recurring theme of all of these short-term initiatives is to enhance the role of the Federal Reserve Board for issues related to market stability.

To a considerable degree, this supplementation of Federal Reserve authority is consistent with the long-term vision for an optimal system of regulatory reform that the Treasury Department articulated in its *Blueprint for a Modernized Financial Regulatory Structure* released in March of 2008.[2] The *Blueprint* envisioned for the United States a three-peaked system of regulatory oversight, built upon separate supervisory units focused on market conduct, prudential oversight, and market stability. As a central bank, the Federal Reserve Board is a natural candidate to oversee market stability and the recent expansion of Board authority on several dimensions could quite reasonably be understood as an expeditious albeit preliminary and incomplete implementation of the larger vision outlined in the *Blueprint.*

What has not yet received attention is whether other aspects of the *Blueprint*'s proposals for consolidation should be implemented and, if so, how those other aspects relate to the on-going

[2] United States Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (Mar. 2008) (avail. online at http://www.treas.gov/press/releases/reports/Blueprint.pdf)

expansion of Federal Reserve Board authority. This paper addresses those issues. Wholly apart from necessary enhancements to Federal Reserve Board authority to ensure market stability, our financial regulatory structure is in profound need of reorganization. Consolidated oversight as implemented in leading jurisdictions around the world offers a demonstrably superior model of supervision for the modern financial services industry. While regulatory failures of the past decade can be traced to many causes, our fragmented system of oversight necessarily narrowed the field of vision of every regulatory body and undoubtedly dissipated supervisory resources through inevitable and persistent jurisdictional squabbles. While the precise cost of these inefficiencies and conflicts is difficult to quantify, they undoubtedly impeded the ability of regulatory officials to appreciate the implications of mortgage market developments for the economy at large and to engage in an accurate assessment of risks from a wide range of sources, including abusive lending practices with respect to credit cards as well as mortgages, excessive reliance on credit ratings for increasingly complex structure products, the continued exposure of many financial institutions to off-balance sheet entities, and the failure of either current liquidity or capital safeguards to ensure solvency of major firms in times of market turmoil. A more consolidated supervisory structure might well have done a better job anticipating and addressing these problems, all of which transcended any one sector of the financial services industry or the jurisdiction of any existing regulatory body.

Beyond the fairly straightforward benefits of organizing financial regulatory oversight along the same dimensions as the modern financial services industry, consolidated oversight has numerous other advantages, advantages that are becoming increasingly apparent as other leading jurisdictions gain experience with more comprehensive regulatory approaches. Some of these benefits are fairly obvious and stem from the ability of consolidated supervisors to implement consistent regulatory requirements across different sectors, drawing from best practices and past experiences in all sectors. Other benefits are more subtle, such as the capacity of consolidated regulators to attract and retain higher quality of staff and to reassign those staff promptly as needed across different sectors of the industry. Still other benefits concern issues of consumer protection. Some consolidated regulators, notably the British FSA, have developed broadly-based consumer financial education programs and ombudsmen services of the sort unknown in the United States, where our financial education efforts

and mediation services are fragmented and largely ineffectual. A further, somewhat unexpected benefit of consolidated supervision has been the extent to which mechanisms of public accountability have been hardwired into many modern supervisory structures. Whereas critiques of consolidated supervision in the United States often assert that a more unified system of regulatory structure would diminish political accountability, the experience of foreign jurisdictions points in the other directions, with many consolidated regulatory regimes operating under more open systems of public oversight and reporting requirements than their U.S. counterparts currently face. Moreover, problems of regulatory capture – of which we have seen ample evidence in the United States in recent years – are said to be much less severe for jurisdictions with consolidated supervisory bodies, where individual sectors of the industry are less likely to have undue influence.

Another lesson to be learned from the experiences of other jurisdictions is that there are a number of different ways in which financial supervisory systems can be consolidated and how the process of consolidation can be staged. In major markets, reforms are seldom implemented in a single stroke, and the process of consolidation can go on for many years. In some jurisdictions, like Japan, the consolidated supervisor will actually maintain separate operating divisions that focus on traditional sectors, such as banking, securities and insurance. In these jurisdictions, the consolidated agency serves as something of a holding company where cross-cutting regulatory functions are housed and under which traditional sectoral supervisory units are located as subsidiary operating units. In other jurisdictions, such as the United Kingdom, the consolidated supervisor is organized more along functional lines, with separate units specializing in market conduct, complex organizations, and wholesale market activities. But this integrated structure is typically only achieved after many years of sometimes painful reorganizations where considerable attention is expended reorganizing staffs from nearly a dozen sectoral agencies with quite different operating philosophies and regulatory standards.

The path of regulatory reform chartered in the Treasury Department's *Blueprint* contemplated essentially a two-phase approach to reform, starting first with a combination of

existing regulatory units, such as the SEC and CFTC as well as certain banking agencies, and the creation of a new federal insurance chartering agency and then followed by a second step in which all of these federal agencies would be divided into a pair of new bodies, one specializing in market conduct and the other in prudential regulation. Together with a market stability regulator, presumably to be located in the Federal Reserve Board, the *Blueprint* envisioned a three-peak system of financial oversight, modeled loosely on the structure adopted in Australia and the Netherlands. While the Treasury's proposal represents a thoughtful approach and a useful starting point for analysis, this paper advocates a different and more direct path to consolidation.

Rather than leading with the consolidation of supervisory units (that is, merging the SEC and CFTC or combining the banking agencies), the United States should first establish a coordinating body in the form of an independent US Financial Services Authority ("USFSA" or "Authority"), which would be able to achieve immediately many of the key advantages of consolidated supervision in advance of the merger of existing sectoral supervisory units. Even without taking over any front-line supervisory responsibilities, this new umbrella organization could engage in industry-wide risk assessments, the development of consistent regulatory and enforcement standards, the identification and assignment of supervisory responsibilities in disputed or novel cases, the resolution of disputes regarding the jurisdiction of state and federal authorities, the implementation of broadly based financial education programs and other consumer protection measures, and attraction of top-flight regulatory staff. Such an umbrella organization would be a natural successor to the President's Working Group on Financial Markets (PWG), which already fulfills a few of these functions on an ad hoc basis and may soon expand its mandate into some others. But unlike the current PWG, this new umbrella organization would have a permanent staff of its own and would be assigned the responsibility of laying the groundwork for assuming responsibility over existing sectoral supervisory units in a few years time. Whether the resulting organization would ultimately retain sectoral operating divisions (as is still the case in Japan) or move towards a more functionally oriented model (as is the case in the United Kingdom) need not be resolved at this time.

This alternative path to consolidated supervision has many advantages over the approach

proposed in the Treasury *Blueprint*. First, the benefits of consolidated supervision are obtained much more quickly and without the *Blueprint*'s politically charged intermediate step of consolidating existing supervisory units. Second, the approach does not necessitate the highly complex and potentially controversial task of dividing a host of existing regulatory agencies into market conduct units and prudential units and then assigning those units to two new and untested agencies. While the division of market conduct and prudential regulation has been employed in a few other jurisdictions with much smaller and less complicated financial markets, the separation of market conduct and prudential functions has proved complicated, and necessitated cumbersome forms of administrative coordination. A key advantage of a more fully consolidated approach to financial supervision of the sort employed in the United Kingdom and Japan and the sort recommended here, is that the coordination of market conduct and prudential functions is handled within a single regulatory body, free from inter-agency disputes or potential litigation.

The creation of a new and independent coordinating regulatory body is also fully consistent with the establishment of the Federal Reserve Board as the agency responsible for ensuring market stability across the financial services industry. Indeed, the creation of the such a body could actually improve the ability of the Federal Reserve Board to focus its attention on market stability issues. Currently, the Federal Reserve Board is responsible for a hodgepodge of regulatory functions in addition to the oversight of market stability and its other macro-economic functions. The Board maintains the front line regulatory responsibility for many state-chartered banks, the vast majority of which do not present systemic risk issues. It also oversees all bank holding companies, but in a manner that often denies it front line oversight of major operating subsidiaries that are overseen by other regulatory units. The Federal Reserve Board even has responsibility for a limited number of consumer protection statutes, such as the Truth in Lending Act and the Home Mortgage Disclosure Act, though it lacks a robust consumer protection or consumer education mandate. While there are good historical reasons why Congress initially assigned this collection of regulatory functions to the Federal Reserve Board, the resulting collection of responsibilities is peculiar and wholly at odds with the trend around the world over the past two decades to move supervisory functions away from central banks and into consolidated regulatory bodies. The creation of a USFSA would offer a

natural location to which the Federal Reserve Board's extraneous regulatory functions could be transferred. Not only would this allow the Board to focus its attention on macro-economic and market stability issues, it would create two roughly comparable federal entities, each with substantial staffing and industry-wide jurisdiction, thus dividing authority in a balanced manner that would facilitate policy debates and avoid reliance a single regulatory monopoly.

The creation of an independent USFSA would also address another structural problem in federal financial regulation. Currently federal financial regulation is spread across independent agencies (such as the SEC and the CFTC), government corporations (such as the FDIC and PGBC), a smattering of departmental offices (including units in both Labor and Housing and Urban Development), plus a number of offices within the Department of Treasury (including the Office of the Comptroller of the Currency and the Office of Thrift Supervision). One of the defects of this fragmentation of authority is that it forces the Department of the Treasury itself to assume leadership for financial supervision, both in times of crisis and on more routine matters. Around the world, the general view is that financial supervision is best located within independent agencies, which are thought to be more free from the risks of political interference and more likely to attract and retain high-quality staff, particularly in senior positions. If the United States were to move towards a USFSA, it could be structured as just such an independent agency, with all of the appropriate safeguards from both excessive political interference and from the high turnover of key Treasury staff that comes with each new presidential administration.

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The balance of this study elaborates upon this approach to reforming our system of financial regulation. Many aspects of the program would entail federal regulation. Without proposing specific statutory language, the paper outlines the key issues that would need to be addressed., emphasizing areas in which the new consolidated regulatory agency should be delegated authority to develop appropriate administrative structures and resolve jurisdictional disputes. In some areas, it would appropriate for the consolidated supervisor to propose additional legislative actions to complete the process of supervisory consolidation. In a limited number of areas, the President's

Working Group may be able to accomplish certain preliminary steps through executive order, laying important groundwork for the statutory reforms to follow.

I. The authority of the Federal Reserve Board to oversee financial market stability should be expanded to cover all sources of systemic risk in the financial services industry, should be structured to coordinate effectively with other supervisory agencies, and should be designed to allow for consistent, appropriate forms of intervention in response to systemic risks.

In an earlier time, the principle source of systemic risk from the financial services industry came from the commercial banking sector. At that time, it made sense for the Federal Reserve Board to limit its market stability oversight to the banking industry and for its liquidity facilities to be primarily focused on that sector of the financial services industry. But for at least two decades – that is, since the market break of 1987 – it has been clear that our economy has been susceptible to additional sources of systemic risk. The failure of Long Term Capital Management in 1998 and this past Spring's collapse of Bear Stearns offer two prominent examples of nonbanking threats to overall market stability. It is now readily apparent that the Federal Reserve Board needs additional oversight authority and enhanced mechanisms of intervention to address effectively all sources of systemic risk from the modern financial services industry.[3]

The expansion of Federal Reserve Board authority along these lines is fully consistent with the *Blueprint's* recommendation that a single body be charged with responsibility for market stability. While the details as to how this new authority should be defined are beyond the scope of this paper, the overarching goals of this reform should be a) to provide the Federal Reserve Board staff access to sufficient information to evaluate all sources of systemic risk within the financial services industry; b) to ensure that Federal Reserve Board's views on systemic risk are adequately addressed in the ex ante regulation and day-to-day oversight of all sectors of the financial services

[3] Exactly how the Federal Reserve Board's jurisdiction should be defined is an open question. Conceivably, the Board's expanded authority could be articulated with precision, to include for example all securities firms covered by the SEC's consolidated supervised entities program or all primary dealers or all financial services firms with assets over a certain threshold of assets. An alternative and likely better approach would be to define the Board's jurisdiction in subjective terms, for example, embracing all firms and networks of financial transactions that the Board deems to pose potential systemic risk. In addition to avoiding the possibility of failing to specify some as yet detected source of market instability, this approach makes the scope of the Board's supervisory responsibilities more ambiguous, which, as discussed below in Part VI, may mitigate moral hazard problems.

industry that have the potential to pose systemic risks; and c) to require that the terms of the Federal Reserve Board's interventions to address systemic risk be structured consistently and appropriately across all sectors of the financial services industry.

Information Sharing: Information sharing is likely to be the least controversial aspect of the Federal Reserve Board's expanded authority as there is already a fairly well established practice of information among financial regulatory authorities, and familiar mechanisms such as the recent memorandum of understanding between the Fed and the SEC exist to formalize such arrangements.[4] Similar arrangements may be needed to extend the Board's monitoring capabilities to at least some segments of the insurance industry, which may pose significant systemic risk concerns, implying the need for additional information arrangements with state insurance authorities and perhaps eventually a federal insurance chartering agency. Monitoring of some commercial firms with substantial financial activities as well as likely regulated entities such as hedge funds and OTC derivative clearing networks may also be in order. Attention should also be given to other options for deepening the knowledge of Federal Reserve Board staff, such as secunding Board staff to front line supervisory agencies on an interim basis or arranging collaborative research projects on topics related to risk assessment. In some instances, where the front-line supervisory agencies lack sufficient expertise or personnel, Board staff may need to take primary responsibility for on-going supervision on at least an interim basis.

Input into Regulation and Supervision: Structuring Board input into ex ante regulation and daily supervision presents a thornier question of institutional design. Unless the Federal Reserve Board itself is to become a unitary and comprehensive financial regulatory body – a reform that would be at odds with the *Blueprint* recommendations as well as regulatory practice around the world – the Board will need to work with other regulatory agencies that have front-line responsibility for the regulation and supervision. Many aspects of that front-line oversight will have

[4] See Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the Board of the Governors of the Federal Reserve System Regarding the Coordination and Information in Areas of Common Regulatory and Supervisory Interest (July 7, 2008) (avail. at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080707a1.pdf).

potential implications for market stability. Capital regulation, for example, is a form of prudential regulation that both protects individual institutions from insolvency and also protects against the systemic risks that a large institutional failure could precipitate. As the recent subprime crisis reveals, even poorly designed and under-enforced consumer protection can create systemic risks. Moreover, some of the most effective solutions to systemic risk problems are best addressed through ex ante regulation, which front line supervisory units will often be best positioned to police. For example, many of the systemic concerns revealed in the 1987 Market Break were resolved through margin and settlement system reforms that the SEC and CFTC implemented. Similarly, one of the responses to the Continental Illinois Bank failure of 1984 was reform of the structure correspondent banking relationships, a major source of systemic risk in that crisis. One might also imagine that the eventual response to current difficulties with Fannie Mae and Freddie Mac would be to change the way in which OFHEO or its successor supervisor allows those entities to operate in the future. The challenge here is to devise some way for the Federal Reserve Board to give meaningful input to independent front-line supervisors into the design of ex ante regulation and daily supervision of systemically significant entities once the Board determines the systemic risks are present. To the extent that differences of opinion on these matters arise, the matter might be left to inter-agency negotiations. A better approach, however, would be to structure some sort of tie-breaking mechanisms, such as appeal to the Secretary of the Treasury. But the key issue here is to design a workable way for the Federal Reserve Board to make sure that market stability concerns are factored into front-line oversight throughout the financial services industry but without converting the Federal Reserve Board into a comprehensive and all encompassing consolidated financial regulatory and central bank.

Consistent and Appropriate Standards of Intervention: Part of the task in converting the Federal Reserve Board into a comprehensive market stability regulator is to provide the organization with the tools to intervene – whether through emergency liquidity facilities or solvency support – in all sectors of the financial services industry that pose systemic risks. As others have already

noted,[5] the procedures that the Federal Reserve Board followed prior to providing financial guarantees to Bear Stearns were different than those that the FDIC would have had to follow were it to have engaged in a similar intervention to address systemic risk concerns from the failure of a large bank. What has been less widely noted is that the cost of FDIC systemic risk interventions must be recouped from the banking industry through a special assessment on depositors, where any losses that the Federal Reserve Board incurs from its support for Bear Stearns or other recent interventions will be indirectly borne by federal taxpayers. For both equitable and efficiency considerations, the same ground rules for intervention should apply wherever in the financial services industry the Federal Reserve Board determines it is necessary to intervene to prevent systemic risks. The same standards for intervention – perhaps modeled on the 1991 rules that FDICIA established for FDIC inventions – should apply, and also the same rules for recovering eventual government losses from the affected sector.[6] In recent congressional testimony, Federal Reserve Board Chair Bernanke voiced some support for modeling expanded Federal Reserve Board powers on the FDICIA model.[7]

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[5] See Robert C. Pozen, *Think First, Bail Out Later*, N.Y. TIMES, June 15, 2008, at Jonathan Macey, *Brave New Fed*, WALL. ST. J., Mar. 31, 2008, at A19. See also

[6] One of the concerns about expansion of Federal Reserve market stability power is the moral harzard problem created by new emergency liquidity facilities and bailouts. *See infra* Part VI. Requiring the cost of such interventions to be borne by the affected sector serves to mitigate this moral hazard to some degree. It also creates an incentive on more prudent members of the sector to monitor and report excessive risk-taking of their competitors.

[7] See Testimony of Federal Reserve Board Chairman Ben S. Bernanke on Regulatory Restructuring Before the House Committee on Financial Services (July 10, 2008) (avail. at http://www.federalreserve.gov/newsevents/testimony/bernanke20080710a.htm).

II. Even after the authority of the Federal Reserve Board has been expanded, the consolidation of other federal financial regulatory functions should proceed; the experience of other leading jurisdictions indicates that consolidated supervision offer numerous benefits in terms of the quality and completeness of financial regulation and that the principal objections to consolidated supervision can be met through statutory safeguards and institutional design.

A quarter century ago, the regulation of financial institutions here and around the world was overwhelmingly undertaken on a sectoral basis, with the vast majority of jurisdictions maintain separate regulatory agency to police the principal sectors of banking, securities and insurance. In

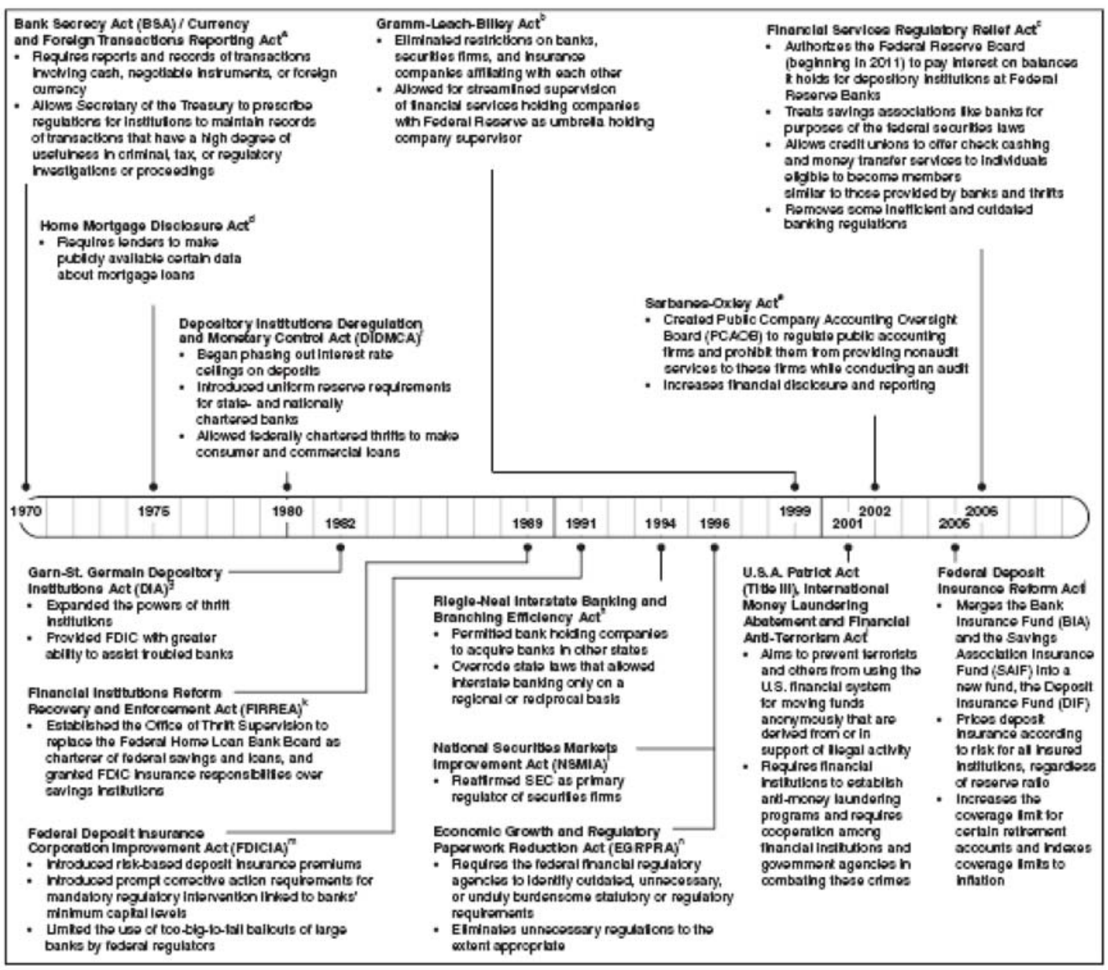
One Regulatory Pillar	Two Regulatory Pillars			Three Regulatory Pillars
	Twin Peaks[1]	Banking & Securities Combined	Banking & Insurance Combined	
Austria Belgium Czech Republic Denmark Finland[2] Germany[3] Hungary Iceland Ireland Japan Korea, Norway Poland[4] Singapore Sweden Switzerland[5] United Kingdom	Australia Netherlands	Luxemburg Mexico	Canada	France Hong Kong Italy New Zealand Portugal Spain Turkey United States

(1) Twin Peaks refers to a division of oversight that is based on regulatory function rather than sector. In Twin Peaks systems, one regulator is responsible for prudential supervision, while a second regulator focuses on conduct of business in the financial sector.
(2) Finland currently has two regulatory pillars, Banking & Securities and Insurance. However, it has established a working group to draft a proposal on how to organize a new integrated supervision authority and to draft any associated legislation. The group will be working until March 2008.
(3) Germany's banking sector is supervised by both the universal regulator and the Central Bank.
(4) Poland currently has two regulatory pillars, Banking and Securities & Insurance. However, it will be switching to a universal regulator in January 2008.
(5) Switzerland currently has two regulatory pillars, Banking & Securities and Insurance. However, it is planning to switch to a universal regulator in 2009.

recent years, there has been a sea change in regulatory philosophy. Overwhelmingly, the movement has been towards more consolidated financial oversight. The accompanying table reports the regulatory structure of 31 leading jurisdictions as of the Fall of 2007, including all OECD jurisdictions plus Hong Kong and Singapore. While a number of jurisdictions are still in transition, the overwhelming trend is towards a more consolidated regulatory structure, whether of the twin

peak variety employed in Australia and the Netherlands or the common fully consolidated models employed Japan and the United Kingdom and adopted or scheduled for adoption in fifteen other OECD jurisdictions. A rapidly dwindling share of the world's financial markets are supervised under a sectoral model of the sort the United States still employs. And, once one factors in our further divisions in regulatory authority across depository institutions (banks, thrifts, and credit unions) plus our delegation to the states of regulatory authority for insurance as well as certain aspects of supervision of depository institutions and securities activities, the United States becomes an extreme outlier compared to other jurisdictions, leading or otherwise.

Figure 4: Selected Legislation Resulting in Financial Regulatory Changes



While the rest of the world has been moving towards regulatory consolidation, the United States has been engaged in other sorts of regulatory reforms. Last year, the Government Accountability Office put together an illuminating charter highlighting the key U.S. regulatory changes of the past thirty years.[8] (See above.) Many of these reforms addressed the issue of regulatory fragmentation, but without undertaking structural reforms. The activities liberalization of Garn-St Germain in 1982 or the Gramm-Leach-Bliley Act of 1999 were motivated in part by a desire to level the playing field across sectors of the financial services industry. Other reforms, including the Patriot Act of 2001, the Home Mortgage Disclosure Act of 1976 and the privacy provisions of the Gramm-Leach-Bliley, articulated new regulatory standards to a range of legal entities that engaged in similar activity, irrespective of their primary regulatory. And other reforms, including NSMIA of 1996 and the securities activity "push-out" rules of Gramm-Leach-Bliley, attempted to resolve festering jurisdictional conflicts among regulatory agencies. Not shown on the GAO chart but also the subject of much legislative attention over the past few decades are efforts to revolve persistent jurisdictional disputes between the SEC and CFTC. But what is strikingly absent from the U.S. reforms of the past few decades has been the absence of any serious organizational consolidation. Apart from the relatively unambitious task of consolidating thrift deposit insurance and bank deposit insurance under the FDIC – a process which required two separate statutory enactments stretching over fifteen years from 1991 to 2006 – Congress has not undertaken any regulatory consolidation in the financial field. Indeed, with the Sarbanes-Oxley Act, it added a new entity in the form of the PCAOB.

Of course, the consolidation of regulatory functions is not a benefit in and of itself. Just because most other leading jurisdictions have moved towards consolidated regulatory structures does not necessarily mean that the United States should as well. However, the emergence of a near consensus among other jurisdictions regarding the desirability of more consolidated financial regulatory oversight should at least raise questions as to whether our national resistance to regulatory consolidation is well-founded. As reported in more detail in an Appendix to this paper,

[8] *See* Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure (Oct. 2007) (GAO-08-32).

the experience of European jurisdictions with consolidated financial supervision does suggest that this approach to regulatory organization offers many potential and important benefits for the United States – benefits that the expansion of Federal Reserve Board authority into market stability oversight does not attempt to achieve. Moreover, many of the concerns voiced by opponents of consolidated supervision appear not to have materialized in other jurisdictions or have been mitigated through safeguards built into enabling legislation. The arguments for and against regulatory consolidation have been rehearsed in numerous fora over the past few years and there is no need to repeat them in detail here. But for purposes of subsequent analysis, it is worth outlining the chief arguments for and against regulatory consolidation and making a few remarks on how the experiences of other jurisdictions can inform our understanding of these issues. For purposes of exposition, I divide these issues into three categories: principal benefits of consolidation; secondary benefits, and principal drawbacks. All of these points are discussed in greater detail in the Appendix.

A. Principal Benefits of Consolidated Supervision

Broadly speaking, regulatory consolidation offers two primary benefits:

1. Comprehensive View of the Financial Services Industry: In contrast to traditional sectoral agencies, consolidated supervisors have a comprehensive view of the financial services industry. This perspective allows consolidated regulators to detect and resolve jurisdictional gaps, to ensure consistency and equality in regulatory standards across sectors, to conduct industry-wide risk assessments, and to address issues of consumer protection and financial education on a system-wide basis. As the subprime crisis of the last few years has revealed, no single regulatory body in the United States has authority over even a relatively narrow area of the financial services industry such as mortgage lending. Many agencies oversee elements of the mortgage market, with important components of consumer protection oversight delegated to poorly staffed offices in the Department of Housing and Urban Development. Similar problems of fragmented oversight hamper our supervision of credit card markets (all federal and state banking agencies, with the Federal Reserve Board staff being responsible for rulemaking under the Truth in Lending Act), collective investment

vehicles (divided between the SEC, Department of Labor, state insurance commissions, and in some instances the CFTC), securities and futures markets (SEC and CFTC), and retirement savings programs (virtually all regulatory agencies plus arguably the Social Security Administration and Medicare agencies). Even if the Federal Reserve Board were to assume comprehensive oversight of all sources of potential systemic risk, the Board would not engage in comprehensive regulation or supervision of the industry. Only a narrow segment of the financial services industry pose systemic risks and the vast majority of supervisory work address other policy concerns, including consumer protection and micro-prudential safeguards.

2. Alignment with Evolution towards Consolidated Financial Services: A second benefit of consolidated supervision relates to the consolidation of financial services industry itself. In order to provide effective oversight of conglomerates that operate across all sectors of the financial services industry and manage risk on a cross-sectoral, integrated basis, modern supervisors need to have expertise in all areas of financial regulation and supervise conglomerates on a comprehensive basis. For this reason, some consolidated agencies maintain specialized departments to oversee financial conglomerates, a practice that is cumbersome and costly to effect in our fragmented system. The existence of financial conglomerates also serves to destabilize sectoral regulation, as conglomerates can swiftly exploit inconsistencies in sectoral regulations, shifting customers and product offerings much more rapidly than the single-sector firms of yesteryear. In other words, our fragmented system of financial regulation is more susceptible to modern forms of regulatory arbitration than are regimes based on consolidated oversight. To meet the challenges of overseeing modern financial firms, regulatory agencies need to operate along jurisdictional lines that roughly match the contemporaneous organization of financial services industry. Again, expanding the Federal Reserve Board's market stability mandate does nothing to address these concerns.

B. Secondary Benefits of Consolidation

Apart from the major arguments in favor of consolidated oversight, experience from other leading jurisdictions suggest that there are a number of secondary benefits, many of which are often overlooked in public discussions of the issues.

1. Staff Quality and Prestige: A good example of an important secondary benefit of consolidated supervision is the reported increase in staff quality and prestige that the new agencies often experience. Partially due to the higher salaries that consolidated agencies often are permitted to pay, agencies such as the Financial Services Authority in London have a reputation for hiring and retaining higher quality staff than their predecessor agencies. For the United States, this could be a significant issue. While some supervisory units – such as the economists at the Federal Reserve Board or lawyers at the SEC – have top flight reputations, the reputation of supervisory staffs across all sectors is decidedly mixed and there are very substantial differences in compensation levels for supervisory personnel from sector to sector. The single-sector focus of our existing regulatory agencies necessarily limits the professional challenges and opportunities of regulatory personnel in the United States. So, while top graduates from the best British universities routinely seek positions as the FSA in London, the same cannot be said of their counterparts at American universities.

2. Leadership in the Reorganization Process: A related and under-appreciated benefit of establishing a consolidated agency is the leadership that agency can provide in moving forward with regulatory reforms. In other jurisdictions, regulatory consolidation is often a multi-staged process, requiring several legislative enactments and a gradual process of consolidating existing supervisory units. The process is often a bit messy, as unforeseen problems arise and the path towards reorganization encounters inevitable difficulties. Once operational, the consolidated regulator itself typically plays a major role in managing that process, from working on statutory language to ensuring continuity of supervision as personnel from existing agencies are merged into the new unit. While the British FSA is perhaps the best example of an consolidated regulator that play a major leadership role in negotiating a successful transition to consolidated supervision,[9] many other jurisdictions have experience a similar process of incremental reforms led by the consolidated supervisor.

3. Cross-Sectoral Insights: Another benefit of regulatory consolidation concerns the

[9] *See* Howell E. Jackson, An American Perspective on the FSA: Politics, Goals & Regulatory Intensity, in REGULATORY REFORMS IN THE AGE OF FINANCIAL CONSOLIDATION: THE EMERGING MARKET ECONOMY AND ADVANCED COUNTRIES 39 (2006) (Lee-Jay Cho & Joonkyung Kim, eds.).

opportunity of cross-sectoral insight that comes from combining personnel previously operating in separate single-sector agencies. Often the learning from one sector is applicable to other areas of the financial services industry. A good example of this within the European Union has been the adaption of risk-analysis technique from the Basel II reforms into the EU's insurance company solvency directives. In the United States, where insurance capital requirements are devised and set at the state level, such cross-sectoral learning is not possible. Similar collaborative learning has been reported at the British FSA in cross-training exercises involving examination and enforcement personnel previously working in different sectors. As functionally similar regulatory tools are utilized across all sectors of the financial services industry and the public policies animating supervision is similar across sectors, there are reasons to believe that the benefits of cross-sectoral insights are genuine and substantial.[10]

4. Internalized Decision Making & Dispute Resolution: A distinct advantage of consolidated supervision is the ability of integrated supervisors to make decisions and resolve jurisdictional disputes internally. This is an important, though often overlooked benefit. In the United States, cross-sectoral regulatory coordination has been a huge problem.[11] Despite periodic congressional efforts to draw clear jurisdictional boundaries and ensure inter-agency cooperation, our regulatory agencies have had great difficulty cooperating in many areas. A good example of these problems is the decade long conflict between the SEC and federal banking agencies over how to implement the rules that Congress set forth in 1999 to grant the SEC authority over most bank securities activities. It took another act of Congress to force the agencies to adopt final rules on this topic, close to a decade after they were first given the charge. While the SEC and CFTC recently

[10] A recent example of how such cross-sectoral learning might be valuable in the United States, consider the decision of government officials to employ bank examiners to get an alternative view on the solvency of Fannie Mae and Freddie Mac, as a check on the view of the GSE's front-line regulator, OFHEO. See James R. Hagerty, *Fannie, Freddie Books Under Scrutiny*, WALL ST. J., July 22, 2008.

[11] Howell E. Jackson, *Regulation of a Multisectored Financial Services Industry: An Exploratory Essay*, 77 WASH. U. L.Q. 319 (1999).

entered into a new memorandum of understanding on regulatory cooperation,[12] the jurisdictional disputes between the two agencies have been legendary, stretching back over multiple decades and prompted numerous legal actions and congressional responses. Among other examples of counter-productive interagency squabbling one could include rifts between federal banking agencies over the negotiation and implementation of the Basel II capital, disputes between state insurance agencies and the federal agencies over the regulation of equity indexed annuities and other novel insurance products, inconsistent bank agency positions on policing the line between banking and commerce, and perennial disputes over the appropriate role of states in policing financial transactions. Disagreements over difficult issues of regulatory policy would not disappear under a system of consolidated supervision, but at least they would be resolved in a timely manner within an integrated regulatory structure, and not bounced around the courts, inter-agency councils and Congress for years and years without definitive resolution or forward movement.

5. Efficiency Gains: A fourth general category of benefits from consolidation are efficiency gains and possibly also cost savings. The empirical validation of these benefits – particularly cost savings – is not well developed, and many proponents of consolidated supervision emphasize the improved quality of consolidated oversight rather than its reduced cost. Conceivably, the United States with its extraordinarily fragmented system of financial regulation would be more likely to enjoy more significant substantial cost savings from reorganization and consolidation of existing agencies, but even if the precise level of efficiency gains cannot be predicted with confidence, it is useful to distinguish at least six different sources of efficiency gains.

<u>a) Combination of Leadership Positions and Administrative Support Services:</u> All independent regulatory bodies have their own top leadership positions – whether executive directors, boards, or directors – and associated staff that would be eliminated in a consolidated regulatory system. Substantial additional savings would be possible in administrative areas, such as human relations, information technology and other support services. The growing staffs that

[12] See Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the U.S> Commodity Futures Trading Commission Regarding Coordination in Areas of Common Regulatory Interest (Mar. 11, 2008) (avail. at http://www.sec.gov/news/press/2008/2008-40_mou.pdf).

many financial agencies now maintain to interact with foreign supervisors could also be combined.

b) Elimination of Fully Redundant Regulatory Functions: Over the past few decades, an increasing number of regulatory structures apply across sectoral boundaries, including money laundering statutes, anti-terrorism provisions, privacy protections, various consumer protection statutes, and tax reporting rules. Among banking agencies, an even larger number of statutory provisions from capital requirements to enforcement rules to data collection requirements, span the jurisdiction of multiple agencies. Regulatory personnel at multiple agencies must maintain expertise on these subjects and negotiate among themselves when new rules are proposed. A consolidated agency could address these topics in a more streamlined and cost-effective manner.

c) Consolidation (and Alignment) of Functionally Similar Regulatory Functions: In a much larger set of cases, sectoral agencies maintain regulatory requirements that take somewhat different forms but serve substantially similar functions. Examples include prohibitions on affiliated party transactions, diversification requirements, standards for judging the fitness of key personnel and controlling shareholders, regulatory exemptions for sophisticated parties, disclosure requirements, fiduciary duties, rules governing enforcement actions, and even capital requirements. Much of the complexity of financial regulation stems from the many different technical requirements applied across various sectors of the industry. (An investment vehicle distributed through an employer-based pension platform is subject to a completely different set of regulations than a mutual fund sold through a brokerage house or an indexed annuity product sold by an insurance agent.) Another potential efficiency gain from consolidated oversight would come from the central administration of these systems of regulation. At a minimum, consolidated supervision would allow a smaller number of personnel to maintain these functionally similar regulatory regimes. More ambitiously, one might hope that a consolidated regulator would be better positioned to determine which of the many different existing approaches to regulatory design constitutes the best practice and then more consistent requirements, unless particular contexts warrant a different approach.

d) Rational Deployment and Redeployment of Resources: A more broadly based regulatory structure also would enjoy potential efficiency gains in deploying and redeploying

resources. Compared to other leading jurisdictions, U.S. financial regulators expend a disproportionate amount of resources on on-sight examinations, enforcement actions, and other forms of hands-on oversight. Even within U.S. regulatory agencies, there are fairly significant differences in regulatory practices across agencies and across sectors of the industry. For example, the Federal Reserve Board system supports a very large staff of highly-trained economists, who have studied the economics of bank mergers in exquisite detail, whereas the SEC maintains only a handful of professionally trained economists and, in retrospect, undoubtedly gave too little attention in recent years to the liquidity risks associated with counter-parties on repurchases transactions. A consolidated supervisory agency would be in a position to evaluate the rationality of our current deployment of regulatory resources and potentially deploy personnel in a more cost effective and productive manner. Equally important, in times of economic turmoil, a consolidated regulator would be better equipped to redeploy personnel from one sector to another, for example, in the current market situation perhaps moving personnel from the PBGC to the FDIC (rather than hiring a new wave of bank liquidators, as is currently the case).

<u>e) Merger of Front-Line Supervisory Functions: Licensing, Examination, Off-Site Surveillance, and Enforcement:</u> Yet another source of potential efficiency gains come from the merger of front line supervisory functions: licensings, examination, off-site surveillance, and enforcement. While public debates over regulatory consolidation tend to focus on this aspect of regulatory reorganization – highlighting the political complexity of merging the SEC and CFTC or combining OTS, NCUA, and other federal banking agencies – this aspect of regulatory reorganization represents only one small piece of supervisory consolidation and is not essential for many of the benefits described above.

<u>f) Efficiency Gains for Industry and Consumers:</u> A final set of efficiency benefits from regulatory consolidation accrue to financial services firms and their customers. Partially, these come from the lower regulatory costs and higher quality supervisory services outlined above. But there are also potential direct benefits for firms and consumers through the simplification and rationalization of regulatory requirements and the ease of maintaining a single point of regulatory

contact.

C. Principal Drawbacks of Regulatory Consolidation

Regulatory consolidation also has several potentially serious drawbacks, many of which resonate with strong American political traditions that favor divided government and a prominent role for state government. There are three principal lines of attack, and for each the experience of consolidated supervisors in foreign jurisdictions is informative.

1. Creation of a Regulatory Monopoly: Perhaps the most trenchant critique of consolidated supervision is the fear that the entity would hold a regulatory monopoly over the entire financial services industry, stifling innovation with a heavy hand and offering no recourse for disgruntled firms. Most commonly this concern is voiced against proposals to consolidated state and federal banking oversight, where the tradition of dual banking has a long heritage, but it is also sometimes raised in opposition to the merger of the SEC and CFTC or the creation of a federal insurance charter that might be expected to dominate our traditional state based system. While complaints of this sort are well grounded in American political traditions, they fail to recognize the realities of the modern global financial markets, where national authorities are constantly confronted with regulatory competition from off-shore markets, including leading financial centers such as London, Hong Kong, and Japan. Whereas state chartering may have produced an important source of competition for national banks in the latter half of the 19th Century, foreign firms are a much more salient form of chartering competition in the 21st. At least judging from the experience in other leading jurisdictions, the problem facing consolidated supervisors is a surfeit of regulatory competition and not a dearth. While off-shore chartering is not a perfect substitute for domestic incorporation in all areas of the financial services market, the presence of foreign regulatory competition does ensure some constraints on domestic regulatory monopolies. At a minimum – in the absence of international harmonization of regulatory standards – the existence of major foreign regulatory structures ensures that alternative systems of regulation will evolve and offer alternative models of supervision against which the domestic standards of a consolidated body can be measured and critiqued.

2. The Risks of Industry Capture: A distinct and to some degree offsetting concern about

consolidated regulatory bodies is the risk that they will become captured by the financial services industry and be led to adopt ineffectual forms of regulation. Here again, the experience of foreign regulators is instructive. To begin with, there is a question of the scope of the consolidated regulator's jurisdiction. In many jurisdictions, like the United Kingdom, the central bank retains residual regulatory authority over market stability and thereby provides an external check on regulatory laxity in the consolidated regulator, essentially a built-in separation of powers. As the Federal Reserve Board will presumably remain the market stability in the United States, this form of check would also exist in this country were we to consolidate other regulatory functions. There is also evidence that regulatory capture is less likely to occur with a consolidated supervisor that has jurisdiction over a number of different kinds of firms and is not as susceptible to the special pleadings of any one sector of the industry. Certainly, if one thinks back over the past few decades of U.S. financial regulatory history, the most egregious instances of agency capture do seem to have occurred when an agency was responsible for a narrow slice of the financial services industry and relaxed supervisory standards to advance the interests of that constituency. Examples would include actions of the FHLBB to sustain insolvent thrifts in the 1980's, efforts by the PBGC in recent years to liberalize funding standards in order to enhance the viability of defined benefit plans, and actions of the OCC in the past decade to enhance the competitiveness of national banks by preempting state consumer protection laws. Quite plausibly, a consolidated regulator less dependent upon any single constituency would have been better equipped to resist special pleadings of these sorts.

3. Lack of Accountability: A related, but more general formulation of the forgoing critiques focuses on the concern that a consolidated regulatory body – with its larger size and broader mandate – would be less accountable to political controls, essentially becomes a government unto itself. Again, this is a topic that has received considerable attention in other jurisdictions, and one on which European academic writers, and particularly British writers, have given a lot of attention and many of their recommendations have been written into the enabling statutes of consolidated agencies. A number of measures have been developed to address the problem of accountability, including the clear articulation of regulatory goals, requirements of annual reports addressing those statutory goals, the appointment and use of advisory councils on various sensitive topics, and other

procedural protections. In the U.S. context, one could imagine other familiar safeguards, such as Senate confirmation of key positions, annual congressional oversight and annual appropriations, plus the various procedural safeguards built into the Administrative Procedures Act and other framework legislation. Many of our existing regulatory agencies operate under statutory structures that are decades and in some cases more than a century old and lack similar systems of political oversight. A new statute authorizing the creation of a consolidated supervisory body could follow recent European models and articulate standards of accountability governing a range of topics, including, for example, consistency of supervision across sectors, consumer protection goals, efficacy and costs of supervision, self-assessments in comparison to other leading jurisdictions, measures of industry concentration, and a host of other metrics.

4. Fairness to Smaller Institutions and Industry Subsectors: – Small firms and narrow subsectors, such as credit unions, present a special challenge to consolidated supervision, as representatives of these constituencies often voice concerns that a consolidated supervisor would favor larger firms and focus on the oversight of complex financial institutions. Concerns of this sort have also arisen in other jurisdictions. One of the difficulties of evaluating such complaints is that these constituencies may already suffer from competitive disadvantages, such as insufficient scale or geographic limitations, and may therefore depend on subsidies built into the current regulatory structure or even tax subsidies, such as the current exemption of credit unions from the federal income tax. Representatives of these groups may oppose consolidated supervision not because it threatens unequal supervision, but rather because it promises a level playing field on which smaller and more narrowly focused firms can no longer compete. The proper response to such concerns is not to abandon consolidated supervision, but rather to allow existing subsidies to persist within a consolidated regulatory structure and to leave the reconsideration of the propriety of these subsidies to a later date. In the meantime, the consolidated regulator can be tasked with monitoring the viability of these sub-sectors and the impact of future regulatory reforms on firms within the sub-sectors, just as the SEC currently monitors the impact its regulatory reforms on small business capital formation.

III: Experience in other leading jurisdictions also demonstrates that many of the benefits of consolidated oversight can be achieved without the statutory consolidation of front-line supervisory units and the world's premiere consolidated agency, the British FSA, was established in a multi-stage process whereby the enactment and implementation of key new substantive statutes did not occur until the FSA has been in operations for several years.

One of the benefits of disaggregating the benefits of consolidated supervision is that it reveals how relatively few of the benefits of consolidation turn on the merger of supervisory functions. Without assuming any front-line supervisory responsibilities, an oversight body with jurisdiction over the entire financial services industry can assess cross market developments and emerging risks, identify potential gaps or inconsistencies in jurisdictional coverage, and resolve inter-agency disputes in a timely manner. Again without infringing upon supervisory responsibilities, an oversight body can perform basic research and policy analysis functions, engage in comparative cost-benefit analysis, rationalize certain support services, and address many overarching issues of consumer protection including financial education. None of these functions entails front-line contact with regulated entities. Regulation – that is the promulgation and interpretation of rules – is more closely associated with supervision, but is often undertaken separately and could easily be moved to a consolidated supervisory body without disrupting front-line supervision. For example, the Federal Reserve Board currently promulgates regulations under the Truth-in-Lending Act, even though those rules are enforced by many other supervisory agencies. In other words, a consolidated agency could go a long way towards developing a consistent set of regulatory requirements, resolving jurisdictional disputes, and eliminating opportunities for disruptive regulatory arbitrage without assuming any direct supervisory functions. As explained below, this distinction between the regulatory functions and supervisory ones is critical and offers a pragmatic path for reforming structure of financial regulation that starts first with the creation of a consolidated regulatory body without forcing an immediate disruption in supervisory processes.

To illustrate the distinction between front-line supervision and other regulatory functions, consider how existing consolidated regulators in many leading jurisdictions organize themselves.

In many jurisdictions, including Japan's FSA, separate supervisory divisions are organized along traditional sectoral lines, including banking, securities and insurance. Northern European jurisdictions often also follow this model. In these agencies, the supervisory divisions have a large degree of autonomy and the creation of a consolidated regulatory body has not substantially affected their day-to-day operations. The value of consolidation in these jurisdictions lies primarily in the coordinating functions and industry-wide perspective of the higher reaches of the consolidated agencies. In the British FSA, which represents a more integrated approach to consolidated oversight, supervisory operations have been more substantially reorganized, and are now broken down into units focusing on retail markets and wholesale/institutional markets. But even in the British system, many oversight functions are located in divisions that are independent from front line supervision with separate lines of reporting authority These include the strategy and risk division, the general counsel's office and the enforcement division.

The lesson for the United States is that regulatory reorganization need not entail the immediate combination of our entire system of supervisory units. Rather, reorganization could and should be staged in a series of phased steps whereby the most important coordinating and oversight functions are first consolidated and the supervisory components of the industry integrated at a later date, perhaps following the Japanese model operating as separate divisions within a consolidated agency for many years to come. The next section sketches out how such approach to regulatory consolidation could be staged. In addition to achieving many of the principal benefits of consolidated supervision in the immediate term, this staged approach addresses one of the most formidable challenges of regulatory reorganization in the United States, which is dealing with the very substantial scale of our regulatory organization. With more than 43,000 government personnel currently dedicated to financial regulation in the United States, the size of our supervisory apparatus dwarfs that of all other leading jurisdictions. The British FSA, for example, has a staff of roughly 3,000 personnel, more than an order of magnitude smaller than combined U.S. supervisory operations. The abrupt merger of so many people in such a diverse set of supervisory units would pose serious problems of organization and continuity. A stage reorganization ameliorates these problems.

Again, international experience on regulatory reorganizations over the last decade is helpful. In the United Kingdom, the process of establishing the British FSA took a number of years. While the Blair Administration committed itself to the creation of a new consolidated agency in May of 1997, the reforms required several different pieces of legislation, adopted over several years culminating with the enactment of the Financial Services and Markets Act of 2000, which was not implemented until the end of 2001. In its early days of operation, the British FSA operated through the corporate shell of one of the existing agencies, to which the Bank of England transferred 450 of its bank supervision personnel, pursuant to the Bank of England Act of 1998. Then, relying on existing powers to delegate functions, more than half a dozen other existing and legally distinct government departments, independent agencies, and self-regulatory organizations contracted with the FSA to take over supervisor functions on a contractual basis. Although some organizational functions – authorizations, enforcement, and back-office activities – were immediately centralized, roughly 60 percent of the personnel transferred to the FSA continued to perform the same activities they had undertaken in their old agencies, albeit in a new physical location as the FSA opened its Canary Wharf offices in November of 1998. Only over time were front-line supervisory functions of the FSA reorganized into a more integrated manner with the statutory basis of the new approach not enacted until the Financial Services and Markets Act of 2008, itself not implemented until the end of 2001. Much of the work of the British FSA in its early years consisted of drafting and refining the agency's permanent regulatory structure, and working to integrate personnel from more than a dozen preexisting agencies into a new, integrated and cohesive unit. While at the time the process struck some as ad hoc, the British FSA is now generally regarded to be one of the world's premiere regulatory bodies. The lesson for the United States is that this organization was not built from the bottom up through a consequence of mergers of existing operating units. Rather it was built from the top down, starting first with the appointment of a strong executive in the form of Howard Davies and the articulation of legislative mandate to create a world-class regulatory body committed to achieve specific statutory goals.

IV. Drawing on these experiences, U.S. regulatory consolidation should follow a four-stage process: 1) immediate enhancement of the President's Working Group on Financial Markets ("PWG"); 2) prompt enactment of legislation creating an independent United States Financial Services Authority ("USFSA" or Authority") to provide industry-wide oversight, coordinate existing regulatory structures, and lay the groundwork for combination of existing supervisory agencies; 3) a second round of legislation authorizing the merger into the USFSA all other federal supervisory agencies; and 4) ultimate resolution of the organizational structure of the Authority should be postponed until regulatory consolidation is complete.

As described above, many of the most important benefits of consolidated supervision can be achieved in advanced of the merger of front-line supervisory units. As supervisory mergers have proven to be amongst the most politically intractable aspects of regulatory reform, this insight suggests that U.S. regulatory reorganization should seek first to advance the less controversial aspects of regulatory reorganization and put off the more difficult issues of supervisory mergers for a later date. In addition to its pragmatic advantages, this approach also tracks the successful British model in which the creation of the British FSA preceded its assumption of full supervisory responsibilities by a number of years. The four-phase approach to regulatory reorganization sketched out below is intended to be suggestive, rather than comprehensive. Many details would need to be resolved in implementation, but the basic strategy is straightforward. Start immediately with expansion of the PWG, the one currently-existing administrative unit that has a mandate to oversee the full financial services industry Then adopt legislation that creates an independent consolidated regulatory body with statutory powers to achieve the most important benefits of consolidated oversight. Leave the more complicated issues involved in merging supervisory units to a third phase of reorganization, and the ultimate organizational structure of the consolidated regulatory agency to a fourth phase. Embed in all enabling legislation appropriate safeguards to insure accountability and effective political controls.

Phase One: Immediate Expansion of the President's Working Group on Financial Markets to Provide a Broader Perspective on the Financial Services Industry

As the Treasury *Blueprint* itself recommends, the most immediate path to enhancing the oversight of the financial services industry is to expand the authority of the Presidents Working Group on Financial Markets. Since its creation in 1998, the Group has principally focused its attention on responding to industry-wide systemic risks, such as the market break of 1987, which prompted the initial creation of the group, or more recently perceived risks posed by hedge funds, OTC derivatives, and most recently the credit crisis. The *Blueprint* recommended that the group's authority be expanded to consider issues of consumer protection as well as other issues of industry-wide concern, and a new executive order effecting that recommendation is apparently now under review.

Following the *Blueprint*'s lead, one could imagine using the enhanced PWG structure as a platform for achieving several of the benefits of consolidated oversight outlined above. To be sure, the PWG is not a perfect vehicle for addressing regulatory deficiencies, as there are many functions that the group could not assume without new statutory authority from Congress. But there do exist a number of analytical and advisory functions that an expanded PWG could perform in the absence of new legislation. Under the assumption that a number of months (and perhaps even years) may elapse before Congress adopts enabling legislation, it make sense to focus initially on the kinds of functions the PWG could fulfill in the interim to address the shortcomings of our existing system of fragmented oversight. Such an expansion might include the following elements:

1. Creation of an Executive Director and Permanent Staff. One of the limitations of the current structure of the working group is that it operates only as a coordinate council of principals, headed by the Secretary of the Treasury, but without any dedicated staff of its own. In order to assume a larger role and expand its activities beyond its current role in responding to systemic crises, the Group should have a dedicated executive director and permanent staff, some of whom might be secunded on a long-term basis from existing agencies to reduce budgetary demands. While, as discussed below, the consolidated regulatory agency should itself be structured as an

independent agency, the staff of an expanded working group should remain within the Department of Treasury.

2. Industry-wide Risk Assessment. Most likely, the primary role of the expanded Working Group will continue to be a focus on systemic risk concerns, but perhaps with somewhat more effort being given to forward-looking analysis than has been true in the past when the PWG has mostly reacted to emerging problems. An interesting aspect of this feature of the Group's mandate will be its relationship to the Federal Reserve Board, as the Board assumes more comprehensive authority to monitor systemic risk as the agency charged with ensuring market stability. Over time, this traditional function of the PWG may logically be transferred to the Federal Reserve Board.

3. Global Consideration of Consumer Protection and Consumer Education. As the *Blueprint* anticipated, the PWG is also well positioned to play a coordinating role on issues of consumer protection and financial literacy. This would be a new role, but it is an entirely sensible one. The Treasury Department already has some expertise on these topics, and those resources could operate as part of the expanded Group's staff. An important initial task would be the coordination of responses to the unfolding subprime crises. A host of federal agencies are currently considering reforms to address the consumer abuses in mortgage lending over the past decade and coordination in effort is clearly needed.

4. Gap Detection/Recommended Allocation of Jurisdiction. Another role that an expanded Working Group could assume is the detection of regulatory gaps and recommended allocation of responsibility to existing agencies. While the Group's judgments on these issues would not be binding – at least in the absence of new legislation – a disinterested review of these issues could still be useful and might prevent the sort of inter-agency squabbles that have plagued the financial services industry for the past few decades. At any given time, there are a host of jurisdictional disputes between the SEC and the CFTC or federal authorities and state insurance regulators, and the Working Group could begin to assume the role of cross-sectoral referee.

5. Review Existing Regulatory Structures for Consistency, Coherence and Efficiency. An

expanded PWG could also fulfill a number of rules in enhancing the consistency, coherence and efficiency of existing regulatory structures. This work could take the form of undertaking cost-benefit analysis of new regulatory initiatives or commenting upon agency staffing and budget requests in the course of annual appropriation processes.[13] The Group might also attempt to identify major inconsistencies or discontinuities in existing regulatory requirements, both to encourage inter-agency coordination and to limit regulatory arbitrage. Finally, the PWG staff might strive to coordinate and rationalize research and risk assessment across disparate regulatory bodies. As almost all of this work would need to be hortatory or advisory, the PWG could not be expected to operate as effectively as a full-fledge consolidated agency, but it might be expected to achieve some of the benefits of consolidated oversight in advance of enabling legislation.

6. Participate in the Drafting of Phase Two Legislation. A final and critical role for the expanded working group would be to participate in the drafting of legislation for the second phase of reorganization.

Phase Two: Creation of an Independent United States Financial Services Authority to Assume Statutory Responsibilities for Coordinating and Rationalizing Industry-Wide Oversight

The next and critical phase of the development of consolidated supervision would be the creation of a new and independent agency with a full panoply of regulatory powers and a modern system to ensure accountability and appropriate political controls. This new agency, the United States Financial Services Authority ("USFSA" or "Authority") would inherit the expanded responsibilities outlined in phase one, but whereas the expanded PWG would have had to rely on exhortation and advisory opinions, the new agency would operate under an explicit statutory mandate. Conceptually, the USFSA would sit on top of all existing financial supervisor authorities,

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[13] To date, U.S. cost-benefit analysis for financial regulation has not been well developed. Edward Sherwin, *The Cost-Benefit Analysis of Financial Regulation: Lessons from the SEC's Stalled Mutual Fund Reform Effort*, 12 Stan. J. Law, Bus. & Fin. 1 (2006).

whether state or federal. While front line supervision would continue to be located in existing units and operate under existing statutory structures, the Authority would have broad powers to rationalize regulatory regimes across the financial services industry, producing more consistent regulatory regimes and moving towards a unified system of regulatory requirements. The Authority would also have statutory authority to make binding determinations regarding jurisdictional disputes and responsibilities to oversee new financial products and services. The USFSA would also be charged with resolving disputes over the appropriate roles of federal and state authorities in policing financial transactions and protecting the interest of consumers, resolving such matters as the appropriate role of state authorities in policing securities firms and the appropriate application of state consumer protection statutes to federally chartered depository institutions. And the Authority would provide a single point of contact for negotiations and interactions with foreign regulatory bodies. In short, this new Authority would be structured to achieve as many of the benefits of consolidated oversight as possible, short of an assumption of responsibility for front-line supervisory responsibility.

In addition to serving as a centralized rule-making body for the entire financial services industry, the USFSA would be the appropriate entity to assume responsibility for new financial regulatory or supervisory operations that Congress might choose to establish. The *Blueprint*, for example, contemplates a new instrumentality to deal with the licensing of mortgage originators as well as a federal chartering authority for insurance companies. Both of these functions might sensibly be located within the Authority, as would any new agency charged with regulating government sponsored enterprises, such as Fannie Mae and Freddie Mac. There has also been much discussion in policy circles of the need to establish a more robust system of consumer protection at the federal level – conceivably a Consumer Financial Product Safety Commission. As the USFSA would be charged with policing consumer protection concerns across the financial services industry, any other expansion of consumer protection should also be located under the auspices of the USFSA.

The quality of personnel assigned to the USFSA would be critical to its success. As mentioned above, one of the virtues of consolidated supervision in other jurisdictions has been its

ability to attract and retain high quality staff. The inherently broader and more challenging jurisdiction of consolidated entities is one reason why such an agency would be more attractive than traditional sectoral entities, but the terms of employment – notably salary and benefits – must also be commensurate with the skills sought. The initial core staff for the Authority would presumably be transferred over from the expanded PWG outlined above, but additional personnel from existing federal agencies – particularly those specializing in policy analysis and the formulation of regulations - would also be likely candidates for transfer or long-term secundment. Should the Authority be charged with industry-wide consumer protection functions of this sort, then it might also make sense to relocate the Federal Reserve Board's entire consumer finance functions to the agency as well. In addition, the Treasury Department offices responsible for overseeing money laundering and anti-terrorist issues might also be transferred to the USFSA.

A final task of the USFSA in the second stage would be formulating a statutory proposal for integrating all federal supervisory functions in the next stage. In addition to technical issues of statutory amendment, the Authority would be charged with ensuring continuity of personnel, including potentially joint training exercises, collaborative projects utilizing personnel from different regulatory agencies, and employee education programs to address questions and concerns about the process. These efforts could be modeled upon the successful efforts of the British FSA in melding personnel from more than a dozen different pre-existing agencies into their consolidated operations.

Phase Three: Transfer of Remaining Federal Supervisory Units to the USFSA

Only in the third phase of consolidation would front-line supervisory units be transferred to the USFSA and that process would happen only after the agency had laid the groundwork in phase two and Congress had signed off on this next step of reorganization through enabling legislation. The transfer would include all existing federal agencies charged with the supervision of depository institutions (that is, the FDIC state non-member bank regulatory functions, the OCC, the OTS, the NUCA, and the Federal Reserve Board's state member bank regulatory functions over oversight authority for bank holding companies). The SEC and CTFC would also be folded into the agency at this stage, as well as the ERISA oversight responsibilities of the Department of Labor and

whatever residual supervisory responsibility for mortgage markets or GSEs remained at the Department of Housing and Urban Development. These transfers need not all happen simultaneously, but could be sequenced over a period of time in order to minimize administrative burdens. At this stage, it would also be sensible to implement the *Blueprint*'s proposal to consolidate federal guarantee functions, including the FDIC's operations for dealing with failed banks, as well as SIPC and the PBGC as well as any guarantee program that might eventually be established to support federally chartered insurance companies. Collectively, these agencies could be operated as a separate division, comparable to the British FSA's compensation scheme, which serves a similar industry-wide function.

Phase Four: Resolution of Long Term Organizational Structure

The last and final phase of regulatory reorganization would entail the long-term organizational authority of the USFSA. As mentioned earlier, the organization of consolidated regulatory agencies differs considerably from jurisdiction to jurisdiction. In some jurisdictions, like Japan, the supervisory divisions are organized along sectoral lines, and that is presumably how a U.S. consolidated regulatory agency might initially choose to organize those divisions immediately after transfer. But it is possible that the Authority would prefer to organize supervision distinguishing retail and wholesale/institutional markets, as is done in the United Kingdom. Or internal operations could be divided into market conduct and prudential units. Or enforcement and licensing could be pulled out of supervision and placed into centralized units. Or a separate division could be created to deal with complex organizations. All of these organizational arrangements – and many more – are plausible and have precedents in other jurisdictions. But the key point for current purposes is that the selection of an optimal organization structure is difficult to do before the reorganization process begins. Under the proposed phrased approach to reorganization, this difficult decision regarding the ultimate form of supervisory organization can be postponed until a later date.

Addendum: Statutory Safeguards to Ensure Accountability and Transparency

Imbedded in the legislation creating and expanding the authority of the USFSA should be

a system of statutory safeguards to ensure accountability and transparency. Again, the European experience in this area would be a useful guide. At a minimum, enabling legislation for the USFSA should include annual assessments on the financial strength and competitiveness of the American financial services industry and reports on consumer protection issues. During phase two of the consolidation process, while federal supervisory agency remain in existence, the Authority might be expected to report on the quality of supervisory oversight and consumer protection for each independent agency, and might also speak to the level of staff and other resources available to each agency and the efficiency with which those resources are being deployed. Both comparative and cross-sectoral studies for regulatory efficiency and enforcement intensity would be useful. To the extent that certain constituencies – small banks, credit unions, or local insurance brokers – were perceived to be vulnerable to disadvantageous treatment under a regime of consolidated supervision, additional reporting on these subsectors could be required. One could also imagine including a network of advisory councils representing certain constituencies to ensure adequate input into and outside oversight of Authority functions. And, the usual requirements for Presidential nomination and Senate confirmation of key agency officials could be employed as appropriate.

Two additional institutional restraints could also be relied upon to prevent agency abuse. The first would come from foreign regulatory bodies. Where financial transactions can be relocated abroad, these foreign agencies offer a direct form of regulatory competition. Elsewhere, they at least provide alternative approaches to regulatory problem, from which a U.S. consolidated regulatory could learn and borrow. Within the United States, the Federal Reserve Board with its expanded authority over market stability will provide another counter-weight to the USFSA, particularly relevant were the agency to accede to industry pressure in relaxing regulatory requirement so as to threaten potential macro-economic ramifications.

V. This four-phase approach to regulatory consolidation improves the likelihood of successful transition by delaying controversial decisions, avoiding unnecessary steps, and providing an organizational structure that can lead reform while safeguarding continuity of supervision.

The Treasury Department's *Blueprint* also consists of a multi-step plan for modernizing financial regulation. Consolidation, under the *Blueprint*, would begin first with the proposed merger of supervisory units – the SEC merging with CFTC along with the combination of several of the federal banking agencies into a consolidated unit with some ambiguity as to whether the Federal Reserve's bank supervision operations would be included. In a distinct and subsequent second step, all of the federal regulatory agencies would be then disaggregated into market conduct functions and prudential functions, which would then be spun off into separate agencies, following the twin-peak model of Australia and the Netherlands. Market stability would remain the province of the Federal Reserve Board and separate agencies would assume responsibility for federal guarantee programs and the oversight of corporate issuers. While theoretical coherent, this approach to regulatory consolidation has numerous shortcomings compared to the phase consolidation recommended here.

First, the Treasury program of reorganization begins with supervisory mergers that are highly likely to generate the intense political resistance. The first step of reforms are apt to stall in the face of predictable congressional resistance bolstered with intense opposition from well connected lobbyists. Quite possibly, the entire reform effort could run aground at this initial stage. In that case, the *Blueprint* approach might actually leave our regulatory structure even more fragmented than before as the *Blueprint* also recommends the creation of two new supervisory units (one to oversee mortgage broker licensing and another to provide a federal insurance charter).

Second, the *Blueprint* contemplates a rather cumbersome process whereby existing supervisory bodies are first merged together and thereafter desegregated into separate peaks for market conduct and prudential regulation. Combination followed by recombination is an inherently costly path to reform and presents greater risks for continuity of oversight and retention of experienced personnel.

Third, the most important benefits for supervisory consolidation, which require oversight bodies with industry-wide perspective, will not occur under the Treasury proposal until the full process of reorganization is complete. Putting aside the Federal Reserve Board's expanded authority to police market stability, which the *Blueprint* does set as an immediate priority, the Treasury's proposal would leave the development of cross-sectoral prudential oversight or broadly-based attention to consumer protection to the final stages of consolidation. Even then the cross-sectoral oversight will be divided across several bodies.

Fourth and equally important, by failing to establish a consolidated regulatory agency early on in the process, the *Blueprint*'s approach lacks an organizational body to steer the course of reorganization, providing the sort of guidance to the legislature and consideration of personnel issues that was so critical to the success of the British FSA in its early years. Implicitly, the *Blueprint* contemplates that future Treasury Departments will take the lead in steering later stages of reform. But as past experience has demonstrate, the Treasury Department lacks expertise in all areas of financial services regulation and does have the sort of on-going interaction with front-line supervisory units that the USFSA would develop overtime. In addition, as the administrative body into which all federal supervisory agencies would eventually be located, the USFSA would be better positioned to make credible commitments regarding future employment of the sort that could prove necessary to retain key personnel throughout the reorganization process. Finally, as compared to the Treasury, whose senior staff changes with each new Administration, the USFSA would provide a more stable and cohesive body over the long term.

Finally, the *Blueprint* commits itself to an ultimate regulatory structure – multi-peak regulation by objective – that has only been adopted in two relatively small jurisdictions, Australia and Netherlands. Even in those markets, the problem of coordinating between market conduct and prudential regulators has sometimes been problematic, and many outside experts have questioned whether the United States might not be better advised to pursue a more consolidated approach to financial supervision of the sort adopted in major markets like the United Kingdom, Japan and

Germany.[14] By postponing the unification of sectoral supervisors to a later stage, a phased approach to consolidation recommended here postpones these difficult decisions until the USFSA has accumulated greater experience with the reform process and can develop a more considered analysis of this difficult question of regulatory design. If the Authority then determines that it makes sense to separate market conduct from prudential regulation, that division can be effective through internal reorganizations within the USFSA. But the Authority would not be locked into that approach at the outset, as would be the case if the *Blueprint*'s approach to optimal regulation were followed.

[14] See Howard Davies, *Sharks Circle Paulson's Aussie Plan*, FIN.TIMES, Apr. 1, 2008.

VI. The creation of a USFSA is also consistent with expansion of the Federal Reserve Board's role in overseeing market stability and would actually improve the capacity of the Board to perform that function effectively.

The relationship between the proposed USFSA and the Federal Reserve Board's expanded role as market stability regulator is an important one. Like the Treasury Department's *Blueprint*, the current proposal envisions splitting over the responsibility for market stability from more routine functions of financial regulation. The Federal Reserve Board will specialize in the former and the USFSA would be responsible for the latter. This division of responsibility should prove advantageous to both organizations.

With respect to the Federal Reserve Board, the existence of an independent federal agency with broad authority over the financial services industry will allow the Board to shed a number of its current supervisory functions that are not central to policing market stability. Over the years, the Board has accumulated a host of peripheral tasks, ranging from direct supervision of state members banks (whether or not of significant size), supervision of all bank holding companies (even those with only small bank subsidiaries), and a variety of consumer protection topics including Truth-in-Lending Act responsibilities and the administration of Home Mortgage Disclosure Act. In the absence of any other federal agencies to whom to assign such responsibilities, Congress has also treated the Board as a regulator of last resort for a variety of cross-cutting topics. This practice has a number of unfortunate consequences. First, when the Board assumes responsibilities that do not directly relate to macro-economic issues, it tends not to give those matters the attention or focus those activities deserves. Conversely, when a division of the Board assumes routine regulatory responsibilities, the rest of the Board staff seems not to consider whether its performance of those responsibilities raises systemic concerns.[15] The ongoing credit crisis offers examples of both problems. As much as any other federal agency, the Federal Reserve Board staff was responsible for the regulation of the subprime market (through its authority under TILA and HOEPA) and the

[15] For an even more harsh view of the Federal Reserve Board's record of supervision and regulation, see Allan H. Meltzer, *Keep the Fed Away from Investment Banks*, WALL ST. J., July 16, 2008.

development of bank capital standards, examples of market conduct and prudential oversight respectively. In retrospect, the Board's regulations in both areas proved inadequate in fulfilling their narrow goals of protecting consumers or accurate capturing off-balance sheet exposures of banking organizations. These regulatory failures also generated substantial systemic risks that the Federal Reserve Board's macro-economic staff largely overlooked. Had the Board not played such a direct role in developing bank capital rules over the past decade, perhaps the Board might have detected the systemic flaws in our bank capital requirements. Similarly, had the Board staff itself not been responsible for devising disclosure rules for subprime loans, perhaps the Board might have detected the systemic risks those loans posed to the larger economy.

With the creation of the USFSA proposed here, there would be a clear division of supervisory responsibility. The development of routine regulation governing both consumer protection issues and prudential concerns would be transferred to the USFSA in the second phase of consolidation, and the banking supervision function (as well as the bank holding company oversight function) would be moved over in the third phase. This reorganization would consolidate ordinary regulatory functions in the USFSA and leave the Federal Reserve Board staff free to focus on market stability concerns that are more directly tied to the Board's other macro-economic mandates. To be sure, this transfer of authority will remove from the Federal Reserve Board any front-line supervisory responsibilities. But similar reorganizations have been common around the world for the past two decades, most notably in the United Kingdom, and a variety of mechanisms have been developed to ensure that central banks remain abreast of current market developments. Information sharing arrangements, periodic rotating of personnel, and other cooperative arrangement can all serve to maintain connections. But primary, front-line supervision would be the task of the USFSA.

While traditionalists will no doubt resist the loss of the Board's front line supervisory functions over banks and bank holding companies, it is important to appreciate how the expansion of the Board's market stability mandate all but necessitates that it pare back its supervisory functions. While the precise scope of the Board's new powers remain to be determined, that

authority will almost certainly include the responsibility to monitor and potentially support systemic risks presented by securities firms, insurance firms, and other economically significant entities including hedge funds and perhaps even some large commercial firms with substantial financial activities. Unless the Board itself is to become the country's full-scale consolidated regulator – a development that would be wholly inconsistent with trends around the world – the Board will necessarily police market stability in many area where it lacks supervisory controls. While inertia could cause the Board to retain supervisory power over its current docket, the better approach would be to refine the Board's power in the upcoming round of regulatory reorganization to give it a consistent set of powers to police market stability and divest itself of all routine forms of routine front-line supervision and consumer protection.

Moral hazard problems associated with the expansion of Federal Reserve Board authority also counsel for the segregation of routine supervision from market stability oversight. As Peter Wallison among others have argued, one of the chief drawbacks of expanding the Board's authority is the possibility that market actors will now assume that any entity supervised by the Board will be protected by a federal safety net.[16] This problem will be particularly acute if the Board takes on any new direct supervisory powers over some enumerated list of systemically important jurisdictions. By ceding direct supervision to a USFSA and retaining an amorphous, but broadly articulated power to intervene to address systemic risks, the Board can lessen these moral hazard concerns. (This approach also finesses the dicey problem of defining which intermediaries and other entities are systemically significant).

A final point concerns the value of having two major federal agencies with distinctive, but somewhat overlapping responsibilities for the financial services industry. As mentioned earlier, one of the legitimate objections to a USFSA concerns the danger of creating a regulatory monopoly that would be either incentives to market developments or captured by industry interests. From the perspective of institutional design, keeping the Board out of the business of routine regulation and front-line supervision but making it responsible for monitoring potential sources of systemic risk

[16] *See* Peter J. Wallison, *The Fed and Investment Banks*, FIN. TIMES, July 9, 2008.

could be extremely valuable. The Board will thus serve as a check on the activities of the USFSA, and would presumably have the power to intervene if the Board staff were to determine that the agency's regulatory practices posed systemic risk concerns. This second look could help the USFSA resist industry pressure to relax regulatory requirements.

Appendix

Consolidated Supervision in Europe: Lessons for the United States*

I.

In modern debates over financial regulatory consolidation, the issue is typically framed in terms of a question of the degree to which and the manner in which traditional sectoral agencies should be consolidated into a smaller number of regulatory bodies. There are two basic approaches to consolidation. The first and simpler approach is to combine two or more sectors of the financial services industry under a consolidated regulatory body, such as the British Financial Services Authority. (Jackson 2006) Alternatively, existing agencies can be reconstituted into new and specialized organizational units designed to advance specific regulatory objectives, like ensuring the fairness and transparency of interactions between financial firms and their customers (sometimes called market conduct) or safeguarding the safety and soundness of financial institutions (often denominated prudential supervision). Adopting terminology coined by Michael Taylor, this second approach is often labeled a "twin peak" or "multi-peaked" model, depending on how many different regulatory objectives are specified and assigned to separate agencies. (Taylor 1995) The Treasury Department's recent *Blueprint* contains elements of both approaches. In terms of combinations, the Department recommends in the relatively near future the merger of the SEC and CFTC as well as the consolidation of banking supervisory bodies, and includes its proposed merger the Office of Thrift Supervision with the Comptroller of the Currency and also its more obliquely recommended combination of the currently divided FDIC and Federal Reserve oversight of state banks. (United States Department of the Treasury 2008, pp. 89-100) Over the longer run, the proposal envisions the creation of multi-peaked objective-oriented agencies, focusing on prudential regulation, market conduct, and market stability, an objective focused on minimizing systemic risks. As the Treasury also envisions the creation of two smaller regulatory units – one for oversight of corporate issuers and the other to contain government guarantee funds – the Blueprint's long-term recommendations might best be labeled a "Three Peak, Two Foothill" model of regulation. (United States Department

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of the Treasury 2008, pp. 137-180)

Within policy circles, the debates over the reform of financial regulatory systems have been well-rehearsed at this point, and the basic trade-offs are fairly well understood.[1] The combination of single-sector agencies offers the promise of greater efficiency and efficacy, as consolidated agencies enjoy economies of both scale and scope. The advantages are, it is argued, capable of simultaneously improving the quality and lowering the cost of financial supervision, while also benefitting regulated firms by offering a single point of supervisory contact and eliminating sources of regulatory duplication and inconsistency. The on-going consolidation of the financial services industry is often cited as further justification for the combination of supervisory functions, as an integrated regulatory supervisor is said to be better equipped to oversee conglomerates that offer a full spectrum of financial products and manage their own risks on an organization-wide basis. The growing dominance of financial conglomerates in global markets also raises the costs of single-sector supervision, as consolidated firms are thought to be more capable of exploiting opportunities for regulatory arbitrage – that is, instances in which different regulators establish different substantive rules to deal with functionally similar products or activities – which single-sector agencies have difficulty identifying and correcting. Relatedly, consolidated agencies are thought to be better equipped to identifying regulatory gaps, that is, pockets of economic activity that fall outside the remit of traditional financial sectors, with hedge funds and perhaps sub-prime mortgage lending activities and securitization activities being prominent examples in recent times.

The case against regulatory consolidation is also multi-faceted. To begin with, there is the absence of irrefutable evidence that consolidated agencies are any more efficient than their single-sector predecessors, at least in terms of total regulatory costs.[2] More substantively, critics of consolidated supervisory argue that the goals of supervision differ across industry sectors and that a combination of regulatory functions may actually dilute the quality of supervision by imposing a

[1] For more extensive treatments of the subject, see Herring and Carmassi (2008); United States Government Accountability Office (2007); Brown (2005); Llewellyn (2004); Masciandaro and Porta (2004); Briault (2002); Di Giorgio and Di Noia (2001); Abrams and Taylor (2000); Schooner (1998).

[2] See Ćihák and R. Podpiera (2006) (finding evidence of quality improvements not cost savings from consolidated supervision).

standardized model of oversight on all sectors of the industry. Combined oversight may also diminish market discipline as government guarantees traditionally limited to certain sectors, like banking, may be assumed to extend more broadly in a country where all sectors have a common supervisory agency. In addition, there is concern that regulatory consolidation produces a governmental monopoly, less likely to respond to changing market conditions and potentially more prone to wholesale regulatory capture or at least a supervisory posture tilted in favor of large conglomerates at the expense of smaller more specialized firms.

Regulation by objective, the third multi-peaked model of regulatory organization, is a bit of a hybrid approach and thus shares some of the advantages and disadvantages of the two other models. (Kremers, Schoenmaker and Wierts (2003)). By reducing the number of supervisory units, regulation by objective offers potential efficiency advantages over traditional sectoral regulation, and it also addresses concerns of regulatory arbitrage as functionally similar products and services are under the jurisdiction of the same supervisory body. But, like fully consolidated oversight, regulation by objective risks imposing one-size-fits-everyone rules, which discount unique characteristics of traditional sectors and subsectors. Moreover, multi-peaked models generate new problems of coordination, duplication and gaps, as the lines between functions such as market conduct, prudential regulation, and market stability are not clear, and many regulatory mechanisms, like disclosure or even capital requirements, advance all three objectives. With regard to concerns over governmental monopolies and supervisory rigidity, multi-peaked models again constitute an intermediate case, less centralized than fully consolidated operations but less attuned to sectoral differences than traditional sectoral oversight.

Another much discussed dimension of regulatory consolidation is the appropriate supervisory role of central banks. Often times, reorganization entails the movement of bank supervision away from the central bank, as happened in the United Kingdom when the supervisory powers of the Bank of England were transferred to the new Financial Services Authority in the late 1990's. Less frequently, but occasionally, the central bank itself becomes the consolidated regulatory, thereby expanding its jurisdiction as a result of reorganization. Finally, in certain multi-peaked models, including perhaps the Treasury Department's *Blueprint*, the central bank may itself be designated the "peak" responsible for market stability. The often voiced concern about this

aspect of regulatory reorganization is whether moving direct supervisory oversight out of a central bank diminishes the bank's ability to effect appropriate monetary policy and maintain financial stability.

Like many important issues of public policy, the debates over regulatory reorganization rests on numerous, conflicting claims regarding the consequences of various kinds of reforms. Seldom do policy analysts have unambiguous empirical evidence to validate their intuitions. But, in the case of the financial regulation, we do have the benefit of looking to the experiences of the dozens of European jurisdictions which have engaged in regulatory reorganizations over the past two decades.

II.

In many respects, the ongoing debate over European regulatory consolidation covers familiar arguments for and against regulatory consolidation, with the growth of financial conglomerates pushing supervisors towards sectoral consolidation and the creation of amalgamated agencies posing concerns over the homogenization and dilution of supervisory oversight. But consideration of the experiences of European consolidated regulators also has important lessons for U.S. observers.

A.

In the United States, one discusses sectoral oversight in terms of the regulatory structure applicable to the core lines of business: banking, securities and insurance. But a recurring theme of European discussions of consolidation supervision is an emphasis on the numerous cross-sectoral regulatory regimes that are already in place in most industrialized countries – money laundering rules, privacy requirements, anti-terrorism measures, and measures to police tax avoidance. (Wymeersch (2007), at pp. 245-246). As is true in the United States, regulations addressing these over-arching issues of public policy tend to be imposed uniformly across the financial services industry – that is, on a consolidated basis – and then implemented on a sector by sector basis. Thus, in even the most fragmented of modern supervisory systems (that is, in the United States), we observe many elements of consolidated regulation, albeit implemented in a haphazard, diffuse and likely inefficient manner.

Another lesson from European practices is the incremental and variegated manners in which

members states have transitioned to consolidated financial services oversight. While foreign observers tend to focus on the fact that a substantial majority of EU member states now maintain consolidated supervisors, front line reporting from Europe reveals that many countries have made the transition only haltingly and often have only gone partway down the path. Moreover, if one looks closely at the organizational structure within the regulatory apparatus of different EU member states, one can often observe that old sectoral models of oversight have not disappeared even within jurisdictions that maintain a single financial services agency.

Consider first the initial stages of financial reform. In many jurisdictions, reform has often been a gradual process. The front end of regulatory consolidation is sometimes accompanied by ad hoc efforts to coordinate sectoral bodies, such as the creation of a coordinating council in the Netherlands and several other jurisdictions or the use of memoranda of understanding to coordinate existing bodies in Germany and the United Kingdom. (Wymeersch (2007), at p. 262) While leading experts report that these preliminary efforts typically lack sufficient strength to effect significant changes in regulatory practices, they often serve as the first step in a complex supervisory quadrille that ultimately results in legislated reforms enacted through parliamentary procedures. If true, then perhaps the much publicized memorandum of understanding between the SEC and CFTC in the Spring of 2008 will someday come to be marked as the opening movement of this process in the United States as would be subsequent efforts to achieve written agreements between the SEC and Federal Reserve Board

Also of potential interest to US observers is the role of industry conglomeration to regulatory consolidation. Within the United States, the merger of banking and securities firms – facilitated by the passage of the Gramm-Leach-Bliley Act in 1999 – has longed been recognized as a reason to develop better coordination between banking and securities regulators. And the decision of the Federal Reserve Board to extend credit to Bear Stearns has only reinforced this process. Within parts of the EU, one sees similar developments, particularly in the London markets, where the lines between major banks and securities firms has long been blurred. But what is interesting about European accounts of industry consolidation is their emphasis on the combination of banks and insurance companies in many continental European jurisdiction and their assertion that the regulatory objectives in these two areas are actually quite closely aligned, focused as bank and

insurance supervision are on prudential oversight and thus highly likely to benefit from integrated supervision. For American financial analysts, less attuned to insurance regulation which is largely regulated to state bodies, the notion that there are serious benefits to be gained from combining banking and insurance regulation is eye-opening, but upon reflection not wholly implausible.

Perhaps the greatest lesson to be learned from regulatory practices in Europe is the array of organizational arrangements currently in place within the EU. Putting aside the several countries that have not yet combined all three core sectors into one body, one still sees ample variation in approaches. On the one hand, many jurisdictions maintain separate sectoral divisions for front line oversight within integrated regulatory structures. This practice is quite common in the Nordic states but exists elsewhere around the world, most notably Japan. In contrast, other consolidated agencies, such as the British FSA, organized their chief supervisory units into retail and wholesale markets (sort of a mini twin peaks approach within an integrated agencies) but also have something of a sectoral matrix approach that maintains expertise along traditional lines but with a special unit for complex organizations. Perhaps not surprisingly, integrated supervision does not in practice consist of an undifferentiated blob of civil servants loosed upon the financial service industry. Rather, in many jurisdictions, operations are divided into supervisory units that would be readily intelligible to one versed only in traditional sectoral oversight.

B.

A commonly cited, but as yet not well documented virtue of consolidated financial oversight is cost savings in government payrolls. Although some proponents of consolidated supervision allude to these financial savings, as well as even greater savings accruing to regulated firms that need only deal with one supervising body (Wymeersch (2007), at p. 263), their emphasis tends to be on the qualitative improvements that consolidated supervisory agencies provide, an aspect of integrated supervision that has been documented in economic writings on the subject.[3]

To begin with the most mundane, many administrative functions are common to all regulatory bodies: personnel offices, information technology departments, various support personnel

[3] For supporting views, see Taylor and Fleming (1999); Ćihák and Podpiera (2006).

at all levels, and even top positions such as the executive director or governing board. (Wymeersch (2007), at p. 260) Aside from the elimination of redundant offices, consolidated departments have inherently larger mandates, which are apt to attract more experienced and senior personnel. Often times, expanded scope will afford increased flexibility, allowing examiners or enforcement staff to be transferred from one sector to another depending on changing conditions.

In terms of substantive expertise, there are to begin with the mounting number of topics – money laundering, tax avoiding, privacy, and financial education – that in many jurisdictions apply to all sectors of the financial services industry and must be staffed redundantly and inefficiently under traditional sectoral regulation. (Wymeersch (2007), at pp. 245-56, 248-49) With integrated agencies, policy making can be combined and streamlined. But if one looks inside the substance of traditional sectoral regulation, there are many more instances of highly comparable matters of substantive expertise: fitness qualifications for new owners or controlling shareholders; suitability standards for investment products (and exemptions for qualified parties); limitations on transactions with affiliated parties; diversification requirements; disclosure obligations of various sorts; and licensing procedures for new firms. (Wymeersch (2007), at pp. 270-71) Most modern systems of financial regulation share these same core elements. While the technical requirements (and even terminology) often differs from sector to sector, the differences are often more the product of historical happenstance than important differences in substantive policy. Attorneys, economists, and other policy analysts trained up to deal with these matters in one sector could quite easily apply their expertise in other sectors. Very plausibly, they would do their jobs better and make life substantially easier for regulated parties if they had the broader remit afforded under a consolidated supervisor. (Wymeersch (2007), at p. 275)

An excellent example of the benefits or a cross-sectoral purview is capital requirements. Much attention has focused on the reform of bank capital requirements under the Basel II process, which has attracted the attention of some of the world's most talented financial economists and been supported by literally hundreds of working papers and dozens and dozens of academic conferences and symposia. Many of the issues that have been explored in the Basel II process – value at risk models, internal ratings, back-testing procedures – are potentially applicable to other types of financial institutions, such as securities firms and insurance companies. Within the more integrated

European system, these connections are more easily drawn. In fact, securities firms in Europe are subject to the Basel II capital requirements (and not the very different SEC net capital rules that are generally applicable to broker dealers in the United States). Even the new insurance Solvency II directive is heavily informed by the Basel II capital rules. (Wymeersch (2007), at p. 269). Thus the oversight of insurance companies in Europe indirectly draw on the expertise of the Basel process in a way that would be difficult to imagine in the United States, where insurance capital rules fall within the bailiwick of the NAIC and state insurance commissions, which have few formal connections to banking regulators and the large number of highly trained economists housed in the federal reserve regional banks.

C.

Another insight available in European accounts of financial consolidation concerns the persistence of jurisdictional and substantive conflicts within consolidated regulatory frameworks and the manner in which those conflicts are resolved. Regulatory reorganizations within the financial services industry do not so much eliminate the existence of conflicts, as they alter the dimension on which conflicts arise and change the locus of their resolutions.

Take the case of the classic form of twin peaks regulation, where market conduct is delegated to one agency and prudential oversight is given to another. While neat this division of authority works well in theory, in practice it entails considerable potential overlap in regulatory design. To begin with, market conduct rules can have prudential implications, as, for example, improper lending practices can give rise to private claims and enforcement actions, which in the extreme can threaten institutional solvency. On the other hand, ample capital reserves – the core of prudential regulation – can have market conduct implications, as well-capitalized concerns are more likely to police their own business activities in order to prevent reputational losses and loss of franchise value. For these reasons, prudential regulators may have different views on market conduct issues that conflict with the views of the market conduct regulator and visa versa. Sometimes, a policy that advances market conduct regulation – say enhanced disclosure of financial weakness – can actually conflict with prudential considerations or even market stability, such that one regulatory body favors additional disclosures whereas another opposes it, and the issue of the proper hierarchy of regulatory functions

is called into question. (Wymeersch (2007), at pp. 245, 249) In the early years of twin-peak regulation in Australia, there were many examples of regulatory conflicts of this sort and it took a number of years (and several memoranda of understanding) to devise a practical system for implementing this form of divided regulatory authority. Similar problems have arisen in multi-peaked regulatory structures in the European context. (Wymeersch (2007), at pp. 247, 267)

With a fully consolidated regulatory structure, similar conflicts arise. If the agency is organized around traditional sectoral divisions, then the same inter-sectoral conflicts arise across divisions. For consolidated agencies organized around functional divisions – that is, replicating multi-peak models within a single agency – the same overlaps and potentially divergent views described above will arise in this context too. What is different about the consolidated agency is where these inevitable conflicts will be resolved, and that is within the agency itself, presumably at the highest level. (Wymeersch (2007), at p. 243; Kushmeider (2007), at p. 337) Conflict resolution in the United States and in other jurisdictions where regulatory jurisdictions is divided across numerous regulatory bodies is more complex. In some instances, cross-agency compromises, typically in the form of memoranda of understanding, can be used to reconcile disagreements. But these are complicated to negotiate and tend to leave important issues unresolved or unforeseen. (Wymeersch (2007), at pp. 267-68) The alternative is resolution in courts or through legislative intervention. (Wymeersch (2007), at pp. 281-82) But these solutions – as exemplified in the United States -- tend to be time-consuming and unreliable, with many inter-jurisdictional conflicts allowed to drag on for years. (Jackson (1999))

In this light, one of the less well understood virtues of consolidated regulatory structures is their built-in ability to resolve through internal mechanisms the inevitable conflicts that arise across industry sectors and regulatory functions. Of course, this advantage carries with it an amplification of one of the greatest potential problems with consolidation, the centralization of excessive governmental authority within a single administrative body, a topic to which I now turn.

D.

Perhaps the most vexing questions surrounding the consolidation of financial regulatory functions concern issues of accountability and maintenance of appropriate regulatory focus.

Especially in the United States, where concerns over aggregation of governmental authority have a special and historic salience, regulatory consolidation is often portrayed as almost un-American on the grounds that divided government is inherently better than centralized authority, at least in this hemisphere. On a more instrumental dimension, the benefits of regulatory competition among diverse and overlapping regulatory agencies are thought to prevent governmental stasis, to combat regulatory capture, and to ensure appropriate regulatory reforms in light of market and technological developments. European experience with consolidated supervision, offers a somewhat different perspective on all of these lines of argument. (Wymeersch (2007), at pp. 277-286)

To begin with, a number of European jurisdictions have attempted to hardwire political accountability into the enabling statutes for their consolidated regulatory bodies. The best example of this is the British FSA, for which Parliament set forth a clear set of regulatory goals and principles of good regulation to which the agency is expected to abide.[4] To ensure fidelity to these statutory guidelines, the FSA prepares annual reports, holds annual meetings, works with a larger number of advisory groups populated with different public constituencies, and – for at least its first decade of existence – seems to have honed fairly tightly to the guidelines that the British legislative process established. Similar mechanisms of accountability are found in other European statutes. (Wymeersch (2007), at pp. 277-79, 81)

Another lesson from European experience is that domestic regulatory competition is not the sole source of competitive pressure on regulatory agencies. Within an increasingly globalized economy, regulatory competition across international boundaries offers a quite plausible substitute for the kind of regulatory competition that once only existed within nation states. (Indeed, within the quite permeable national boundaries of the European Union, regulatory officials more often seem to see an excessive amount of regulatory competition from their cross-border counterparts.) But the key point for policy analysts fearful of the aggregation of regulatory functions within a single national regulatory body is that cross-border regulatory competition is now an important dynamic, which will put a natural constraint on the ability of a domestic consolidated regulator to fall behind

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[4] For a more detailed discussion, see Taylor (2001). See also Hüpkes, Quintyn, and Taylor (2005); Briault (2002).

in regulatory innovations.[5] And, of course, in most jurisdictions, not all regulatory functions are moved into consolidated agencies, with central banks and Ministries of Finance (such as the U.S. Treasury) usually also retaining some market oversight role and a source of internal checks on consolidated agencies.

A final and somewhat surprising insight from Europe is the reportedly diminished role of regulatory capture with consolidated regulatory bodies. Among U.S. academics, one of the principal failings of administrative agencies is their tendency to fall under the influence of the firms they oversee. (Macy 1994) A potential concern about consolidated supervision is that the dangers of regulatory capture could be multiplied as the jurisdiction of the regulatory agency is expanded. But what European regulatory experts report is that the relative power of any sector of the financial services industry is diminished with respect to consolidated agencies and so the ability of any single sector to capture the agency is diminished. (Wymeersch (2007), at pp. 265, 278-79) To be sure, these reports do not ensure that a coordinated effort on the part of the entire financial services industry would not be successful in having undue influence on regulatory authorities. But it does suggest that in at least some instances consolidated agencies may be more resistant to regulatory capture than their single-sector predecessors.

E.

A final insight to be drawn from current EU practices concerns the distinction between financial regulation – the articulation and interpretation of regulatory requirements – and supervision – the application of those legal requirements to particular financial services firms through oversight, examination and inspection, and both formal and informal enforcement activity. While financial supervision in Europe is increasingly implemented through consolidated agencies, financial regulation in the region is often still effected along traditional sectoral lines. The EU directives governing the financial sector are the best example of this phenomenon, structured as they

[5] In a similar vein, interaction with multilateral organizations, such as ISOCO or the Basel Committee on Banking Supervision, provides a further check on any single countries regulator getting too far out of line of evolving international standards.

are around the securities sector (e.g., the prospectus directive, the transparency directive, or MIFID), the banking sector (e.g., the capital adequacy directive and the second banking directive), and the insurance sector (the solvency directive).[6] (Wymeersch (2007), at p. 244). This fragmented law making process produces many of the problems common in the United States. Functionally similar insurance and securities products are subject to different conduct of business rules, creating regulatory anomalies and opportunities for regulatory arbitrage. (Wymeersch (2007), at p. 254 & n. 37) Thus, while much attention has been focused on the supervisory consolidation with many EU member states, many of the benefits of this consolidation are not fully realized as long as regulatory standards are largely set on a sectoral basis. Here seems to be an area where Brussels needs to catch up with the member states.

Another idiosyncracy of the EU regulatory structure is the dispersion of supervisory authority across member states, whether to consolidate regulatory units of the sort found in the United Kingdom or to more traditional sectoral bodies of France and Spain. This phenomenon raises serious questions as to whether regulatory policy established at the community level is being implemented and enforced consistently across the region, issues which the Lampfalussy process was designed to address, but which still has not been fully resolved. (Wymeersch (2007), at p. 288) Perhaps ironically, the principal organizational mechanism being employed to monitor and correct uneven implementation or enforcement is sectoral-based coordinating councils, such as the Committee of European Securities Regulators (CESR). Thus, the fully consolidated regulatory agencies, such as the British FSA or Belgium's Banking, Finance and Insurance Commission (CBFA), find themselves operating under sectoral directives established at the EU level and then coordinating with the authorities of other members states through sectoral counsels such as CESR. It is apparently the fate of consolidated supervisors to have to operate, at least initially, in a world built upon sectoral structures.

While the institutional details of European regulatory organizations reflect many conditions peculiar to the evolution of the European Union and larger issues of constitutional structure, certain

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[6] The financial conglomerate directive would be a counterexample (Wymeersch (2007), at p. 260), as would the privacy directive.

aspects of European practice do, perhaps, have lessons for the United States and other jurisdictions. The distinction between regulation and supervision is an important one. Within the United States there is intense political resistance toward consolidation of traditional supervisory units, whether across sectoral lines, such as banking or securities, or even among depository institutions (such as banks, thrifts, and credit unions) or functionally similar products such as securities or futures. But European practice reveals that it is possible to distinguish regulatory consolidation from a supervisory merger. The United States might possibly proceed with regulatory consolidation – establishing uniform national standards across sectoral boundaries – and still retain supervision and enforcement within our traditional sectoral based oversight units, at least for a transitional period. In many areas, such as money laundering, privacy safeguards, and truth in lending, this is already the state of affairs although these rule-making functions are currently located in different administrative units. Recent initiatives to broadening the Federal Reserve Board's authority over issues of market stability could be seen as a continuation of this process. One could easily imagine the creation of another industry-wide regulatory unit – perhaps built upon the current President's Working Group for Financial Markets – to develop consistent American regulation and associated policy making functions for other areas of financial regulation, including consumer protection, the mechanical aspects of regulation such as fitness standards or affiliated party transactions, and other rules common to all sectors of the financial services industry. In this way, the United States could begin to achieve many of the benefits of consolidated oversight, but without disrupting our traditional supervisory structure and taking on all of the quite formidable political challenges that consolidation of those units would entail.

If the United States were to head down this path, it would become the converse of the current European model. Whereas the EU system now largely depends on sectoral regulation at the EU directive level with mostly consolidated supervision and enforcement among member states, the path toward consolidation that I imagine for the United States would consist of moving towards consolidated regulation through congressional legislation as well as a newly devised regulatory agency to articulate most forms of financial regulation and perhaps the Federal Reserve Board for issues related to market stability, but could retain for some years sectoral supervision and enforcement along current lines. The United States and the European Union could then engage

in a quite interesting form of regulatory competition over which form of financial regulatory consolidation works best.[7]

[7] One of the challenges of devising a more integrated form of financial regulation in the United States is dealing with the fact that the scale of the U.S. economy and its regulatory operations is so much greater than that of other jurisdictions. (Jackson (2006)) For an argument that scale factors should not inhibit full consolidation of financial regulatory functions in the United States, see Brown (2005).

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