

## **For Immediate Release**

**CAMBRIDGE, MA, April 4, 2008** Statement by Prof. Hal S. Scott, Director of the Committee on Capital Markets Regulation, in Response to the Treasury Department's "Blueprint for A Modernized Financial Regulatory Structure"

### **Summary**

**Coordination Challenge:** It is unclear how the actions of five regulatory bodies included in the Blueprint\* would be coordinated.

*\*namely, the "three peaks" it contemplates (separate regulatory bodies charged with market stability oversight, prudential oversight and enforcement of market conduct rules), plus two other bodies that the Blueprint mentions (the Federal Deposit and Insurance Corporation and a new Corporate Finance Regulator).*

**Consolidate Oversight and Enforcement Responsibilities:** Because the line between prudential oversight and enforcement of market conduct rules is not bright, it may be wiser to follow the example of such major financial markets as those in the United Kingdom and Japan, which have chosen to consolidate prudential oversight and market conduct within a single consolidated regulatory body, e.g. the Financial Supervisory Authority in the U.K.

**Make the Supervisory Body Independent:** Supervisory functions should be lodged in an independent body (as is the case in Japan and the U.K.), not located in a political institution like the Treasury.

**Put Fully Consolidated Oversight Before Partial Reforms:** While the Blueprint's proposed initial phase focus on immediate problems is no doubt necessary, we think it unwise to place an intermediate phase of partial consolidation and reform, ahead of moving directly to the larger question of fully consolidated oversight. Congressional leadership and presidential candidates already have expressed a willingness to embrace fundamental regulatory reform and we should move expeditiously towards that goal.

### **Statement**

I applaud Secretary Paulson and his staff at the Treasury Department on Monday's release of its Blueprint for a Modernized Financial Regulatory Structure. The report offers a wide range of thoughtful and innovative proposals to reform the structure of financial regulation in the United States. While the Blueprint's many detailed proposals will no doubt generate much discussion and debate in the weeks and months ahead, we should not lose sight of the fact that the Department has launched an important and long overdue national debate as to the appropriate structure of financial regulation in this country. A better functioning financial regulatory structure would benefit all Americans and is essential for the continued competitiveness of the country's economy. A better regulatory structure would serve the interests of all investors and financial institutions. The Department and Secretary Paulson deserve much credit for launching this process.

The overarching virtue of the Treasury Department's initiative is its goal of creating a world class regulatory structure for the United States. Rather than accepting our current patchwork of regulatory bodies and supervisory practices more suited to the Nineteenth

Century than the Twenty-First, the Blueprint opens a debate on potentially transformative reform of our system of financial regulation. The Department is to be especially commended for looking beyond our national borders to study other regulatory models that are used in today's global financial markets. Whether one considers the "twin-peak" approach of Australia and the Netherlands or the more integrated structures employed in the United Kingdom, Japan, and Germany, all should agree that we must measure the quality of our regulatory structure against the highest international standards. Through this process, we should seek to embrace the best practices without being limited to perspectives from within our existing regulatory structures and U.S. market participants.

Another promising feature of the Blueprint's proposals is its identification of the President's Working Group on Financial Markets as an appropriate and immediately-available platform for coordinating oversight of our financial system. Our Committee called for such an expanded role in its Interim Report of November 2006. In the past few months, the Working Group has played a key role in coordinating the government's response to recent turmoil in the financial markets. The Blueprint envisions that the Working Group will build upon this experience and play a more active continuing role in coordinating financial regulatory policy, paying increased attention to issues of investor and consumer protection across all sectors of the financial services industry, and serving as a national sounding board to ensure that the future reforms are both comprehensive and cost-effective.

Finally, the Department is to be commended in recommending prompt legislative action to enhance the scope of the Federal Reserve Board's statutory powers to match the Board's recent interventions. After all, if primary dealers, which include major securities firms, are to have access to the Federal Reserve's liquidity facilities and lending functions, the Board must have knowledge of the operations and risks of such firms, as well as some supervisory oversight of their activities.

The Treasury proposes intermediary reforms, such as mergers of the Office of Thrift Supervision with the Comptroller of the Currency and the Commodities and Futures Trading Commission with the Securities and Exchange Commission. The Treasury also envisions the creation of two new insurance offices in the Treasury, an Office of National Insurance to regulate insurance companies that would be permitted to seek an optional federal charter and an Office of National Insurance to address international regulatory issues and to ensure proper and coordinated state regulation of state-chartered insurance companies. We believe that the times demand setting aside intermediary steps so that we can begin to create the right federal regulatory structure now. The Treasury has set forth a vision of that structure. From an initial reading, we believe the Treasury's vision raises two overarching questions of regulatory design and one narrower question of implementation.

First, as to regulatory design, the Blueprint proposes as an "optimal" U.S. system a structure consisting of mainly "three peaks," with the Federal Board providing the first peak of market stability oversight and then a second prudential body – to be located within the Treasury Department – providing a second peak of prudential oversight, and finally a third independent regulatory body – presumably built out from a combined SEC-CFTC – that would have responsibility for market conduct rules. In addition, the Blueprint mentions the preservation of the Federal Deposit Insurance Corporation and a new Corporate Finance Regulator. In sum, there would be five regulatory bodies and it is unclear how the actions of these five bodies would be coordinated.

Arguments can be made for dividing prudential regulation from market oversight if the market oversight is to be performed by the Federal Reserve Board, which must remain independent and separate from the rest of the government. However, the line between prudential oversight and market conduct rules is not bright and many prudential regulations, like capital requirements, also protect consumers and investors who are the chief focus of market conduct regulation. Countries that have established separate bodies dealing with market conduct and prudential regulation tend not to have central banks with the kind of strong supervisory authority that the Blueprint rightly envisions for the Federal Reserve Board. We believe, therefore, that we might be better served following the example of the major financial markets, such as the United Kingdom and Japan, which have chosen to consolidate prudential oversight and market conduct within a single consolidated regulatory body, e.g. the Financial Supervisory Authority in the U.K. Consumer and investor protection are extremely important. Putting these functions, along with others, in one body should not and need not diminish the strength of such protections. Also, a unified regulatory structure should not and need not mean all financial institutions are regulated in the same way. The risks of institutions, which often vary with size, would dictate the regulatory approach, not the name or label put on the institution.

A second major question of regulatory design concerns the appropriate governmental location of a consolidated regulator. The Blueprint envisions that at least the prudential regulatory body will be housed within the Treasury Department itself. Again, this is a plausible position, as the Comptroller of the Currency has been housed in the Treasury for nearly a century and a half, and has earned an admirable reputation for expertise and efficiency. This location, however, also has substantial drawbacks. The Treasury Department remains a political institution and is likely to be more heavily influenced by political considerations than would be an independent agency. Again, if one looks to the emerging practices of consolidated financial supervisors around the world, for example the U.K. and Japan, the trend is very much towards moving supervisory functions out of ministries of finance and into more independent bodies.

While the Blueprint's proposed initial phase of actions to address immediate problems is no doubt necessary and desirable, we think it unwise to dissipate energy on an intermediate phase of partial consolidation and reform, rather than to move directly to the larger question of fully consolidated oversight. Congressional leadership and presidential candidates have already expressed a willingness to seek fundamental regulatory reform. Now that the Treasury Department has produced a framework for debating an optimal system of financial regulation, we should move expeditiously towards that goal.