

# COMMITTEE ON CAPITAL MARKETS REGULATION

November 21, 2007

Taiya Smith  
Executive Secretary of the Treasury  
Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, D.C. 20220

Re: Review by the Treasury Department of the Regulatory Structure  
Associated with Financial Institutions (Docket: TREAS-DO-2007-0018)

Dear Ms. Smith:

On behalf of the Committee on Capital Markets Regulation (“Committee”), I am pleased to submit this letter in response to the Department’s request for comments on its Review of the Regulatory Structure Associated with Financial Institutions, 72 Fed. Reg. 58,939 (Oct. 17, 2007).<sup>1</sup>

Over the past decade, many countries have moved towards a more consolidated structure for financial supervision.<sup>2</sup> This trend poses special challenges for the United States, which has traditionally maintained a highly fragmented network of financial regulation. As compared to other leading economies, such as the United Kingdom, Germany and Japan, our system of financial regulation is becoming increasingly anomalous, and the Treasury Department is to be commended for undertaking its current review.

This comment covers two separate points. First, we identify a number of important potential benefits of consolidated financial oversight that are distinct from, and could be achieved in the absence of, the merger of specific supervisory units. Second, we offer several recommendations regarding the manner in which regulatory reform could be staged in the United States with a view towards moving initially on those features of consolidated oversight that could be implemented in the relatively near term in the absence of consolidation of existing

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<sup>1</sup> The Committee has retained Professor Howell E. Jackson of Harvard Law School to prepare an in-depth report for the Committee on reforming the regulatory structure of financial regulation in the United States. The analysis presented in this comment will be amplified in a later report to be issued by the Committee in early 2008.

<sup>2</sup> See Rose M. Kushmeider, *Restructuring U.S. Federal Financial Regulation*, 25 CONTEMP. ECON. POL’Y 325 (July 2007).

supervisory bodies. As a second stage of reform, we recommend that the Department consider the large number of existing proposals for supervisory consolidation, and suggest that the Department expand its analysis to include pension regulation and various financial matters currently under the jurisdiction of the Department of Housing and Urban Development.

### **I. Benefits of Consolidated Oversight of Financial Supervision Apart From Consolidation of Supervisory Functions**

In discussing the British Financial Services Authority (“FSA”) and other recent examples of consolidated financial oversight, observers quite often focus on the most visible manifestation of these reforms – the merger of banking (including thrifts and credit unions), securities, and insurance supervision into a combined agency or group of agencies. To be sure, such combinations do offer potential economies of scale and scope, and also could benefit financial firms by providing a single source of regulatory contact. However, consolidation also raises difficult issues, most importantly perhaps the banking supervisory role of the Federal Reserve. It is important to note that the consolidation of supervisory functions (licensing, examination, enforcement, and standard setting) is not necessarily the most significant feature of these recent financial reforms in other jurisdictions. Indeed, in a number of countries, consolidated supervisory agencies maintain separate supervisory divisions along traditional lines, and only consolidate certain administrative and policy-making functions.

In our view, the most important benefits of consolidated financial oversight are analytically distinct from the combination of supervisory functions. For the United States, we believe it is particularly important that the Treasury Department focus its attention on the broader benefits of consolidated oversight and to consider explicitly the extent to which these benefits might be achieved in the United States without, or at least in advance of, consolidation of supervisory functions. A number of factors argue for this approach. To begin with, the scale of the U.S. financial services industry is so vast that a wholesale consolidation of regulatory functions would potentially create a massive organization, with perhaps more than 43,000 employees compared to the 2,500 to 3,000 employed in the FSA.<sup>3</sup> Moreover, full-blown consolidation of regulatory functions in the United States would raise complicated issues of how to retain the expertise of long-standing organizations with focused regulatory missions, and would encounter potential political opposition from various interest groups. The Treasury Department does not need to resolve the vexing issues associated with supervisory consolidation before achieving benefits of consolidated oversight that are both more important and more easily implemented.

One obvious advantage of consolidated financial oversight that has nothing to do with supervisory consolidation is the benefit that the country would derive from having one governmental body with a view of the entire financial services sector. The unfolding crisis of the subprime lending market offers a good example of a supervisory problem that touches upon bank lending policies (OCC, OTS, FDIC and Federal Reserve), oversight of credit rating agencies and capital markets (SEC), and even the policing of home mortgage originations

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<sup>3</sup> See Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. REGULATION 101 (2007).

(HUD). No single regulatory agency had a full view of the process and there was no obvious mechanism for coordinating oversight, even though problems of subprime lending were identified many years ago and many individual agencies were focused on aspects of that problem.

Another possible benefit of consolidated oversight is the ability to take a more objective perspective on the costs and benefits of regulatory requirements. Although cost-benefit analysis has been a feature of administrative oversight in the United States for many years, financial regulators have not always given the subject as much attention as it deserves.<sup>4</sup> Moreover, even when a regulatory body attempts to perform cost-benefit analysis, the agency cannot help but be influenced by long-standing practices within its sector, whether that be special concern for the interest of consumers or an inclination to tilt towards industry interests. One of the great advantages of consolidated financial oversight is the existence of an organizational unit, both above the fray of daily oversight and somewhat less tied to traditional ways of doing business, to offer a more objective assessment of costs and benefits. One of the great virtues of the FSA is that it has employed precisely this perspective in its development of a risk-based approach to regulation, an approach that sometimes counsels for a lighter touch but also occasionally recommends greater intervention into market practices.<sup>5</sup> Within the American system of government, one could imagine grafting this function into our regulatory system by having a consolidated oversight body offering independent cost-benefit analysis of major regulatory initiatives at the agency level or testifying before Congress on pending legislation or in the annual appropriation process.

An oversight body with a broad perspective on the financial services industry could also play a number of related roles in improving the quality of financial regulation in the United States. Take for example the issues of appropriate allocation of resources. One of the advantages of the FSA is the ability to redeploy staffing and budgetary resources as the supervisory challenges evolve. Even without full consolidation of supervisory function, an oversight body could advise the President and Congress on staffing and personnel needs, recommending for example when resources should be shifted from one sector to another. By providing a venue where supervisory personnel from various sectors could come together to address cross-sectoral concerns, such an oversight body might help facilitate the exchange of cross-industry knowledge and heighten the awareness of alternative regulatory approaches. This education function was a crucial feature of the early years of the FSA and helped establish the agency's reputation for a pragmatic and cosmopolitan regulatory style. In the U.S. context, one might also envision an oversight body playing a coordinating role to ensure that government-sponsored research into pending policy issues (currently conducted on a piecemeal basis within many different organizations) was addressing the most important topics with an appropriately broad perspective. This would be of value by improving our systems of consumer protection and enhancing the prudential side of financial regulation. The President's Working Group on

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<sup>4</sup> 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)

<sup>5</sup> 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.).

Financial Markets (“PWG”) has already taken an important step in this direction through the “Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital” issued on February 22, 2007. This Agreement formulated broad principles that were to be adopted across different regulatory agencies.

Yet another valuable role of a consolidated regulatory oversight body is the capacity to identify and resolve regulatory gaps. With our current system of fragmented regulatory authority, the risk always exists that some new financial product will not fall squarely within the jurisdiction of any single agency. Sometimes industry participants exploit definitional ambiguities to escape regulatory requirements, while in other cases disgruntled customers attempt to recharacterize products in order to initiate litigation with novel theories for legal relief. As history has repeatedly shown, these regulatory gaps often mean that the new product will either escape oversight until a problem arises or engender years of jurisdictional squabbles that delay product introduction until the courts or often Congress intervene to police jurisdictional boundaries. An important function of a consolidated oversight body is to identify new financial products and negotiate jurisdictional disputes before problems arise or regulatory paralysis sets in.

In addition, the regulatory oversight body could serve as the principal point of contact with foreign consolidated regulatory authorities. This would enhance the ability of the U.S. to speak with one voice abroad on important principles of supervision and regulation, and give foreign authorities a counterpart. A step in this direction has already been made through the various regulatory dialogues.

## **II. Developing a Plan for Implementing Organizational Reform**

The gist of the foregoing analysis is that many of the most important benefits of consolidated financial oversight are distinct from the matter of consolidating supervisory functions. Accordingly, we recommend as a first phase of organizational reform the Treasury Department explore the broader and arguably more important benefits of consolidated oversight that can be obtained in the absence of supervisory consolidation. On this dimension, we propose that the PWG represents a promising platform upon which a more robust consolidated oversight body could be built. Supplemented with a permanent staff (drawn in part with personnel seconded from existing regulatory agencies but also including a core of permanent employees), the PWG is well situated to pursue the oversight functions outlined above: taking a global perspective of the financial services industry, developing an unbiased perspective on risk-based oversight of the financial services industry with due consideration of cost-benefit analysis, providing both Congress and the Executive impartial analysis of the efficacy of regulatory reform proposals, identifying jurisdictional gaps and negotiating divisions of responsibility among existing regulatory bodies, and in various other respects ensuring that the financial supervision in the United States moves forward in a sensible manner in keeping with best regulatory practices around the world.

We envision that any new federal insurance chartering agency would be subject to consolidated oversight in the same manner as other federal agencies supervising banking and securities. But state supervision of insurance will remain for insurance companies that do not choose a federal charter, and at present there is no federal charter option. We envision that at

some level state supervision of insurance would also be subject to consolidated oversight at the federal level.


As an important second stage, the Department should consider important issues of organizational reform of supervisory units. Much has been written already about the potential value of consolidating federal banking agencies, combining the SEC and CFTC functions, and adding a federal insurance charter. We will not review the issues here. Also of potential value could be the combination of federal insurance programs for financial institutions, bringing together the FDIC, SIPC, PBGC and potentially a new federal indemnity fund for federally chartered insurance companies. Also relevant to consider in the area of supervisory functions is the need to include the pension regulatory functions now housed in the Department of Labor and Internal Revenue Service as well as the mortgage lending and GSE oversight functions located in the Department of Housing and Urban Development.

But, to revert to the principal message of this comment, an essential first step for regulatory reform is to establish in the near term a consolidated oversight body to grab the low-hanging fruit of organizational reform that can be achieved in advance of any supervisory consolidation. Not only does this approach offer the promise of relatively quick benefit for the U.S. economy, but it also creates an expert body that could take on as its first task the development of a sensible and well-considered plan for supervisory consolidation for implementation in the second phase.

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On behalf of the Committee on Capital Market Regulation, I would again like to commend the Department for taking on the important topic of regulatory reform. The Committee looks forward to working with the Department on this issue and providing whatever assistance we can in this initiative.

Sincerely yours,



Hal S. Scott  
Director, Committee on Capital Markets Regulation