



# Federal Financial Services Regulatory Consolidation: Structural Response to the 2007-2009 Financial Crisis

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## Summary

To address the causes of the 2007-2009 financial crisis, three major proposals have been put forward that would consolidate at least some parts of the federal financial regulatory structure: the 2008 Department of the Treasury Blueprint for a Modernized Regulatory Structure (the Henry Paulson Plan), the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173), and the Restoring American Financial Stability Act of 2010 (RAFSA) introduced by Senator Christopher Dodd, chairman of the Senate Committee on Banking, Housing, and Urban Affairs. Even though these three proposals would not establish a single federal financial services regulator along the lines of Japan's Financial Services Agency (FSA) or the United Kingdom's Financial Services Authority (FSA), the three proposals are the federal government's attempts to remedy the causes of the financial crisis by simplifying and adding transparency to financial services regulation.

Before the financial crisis, there were a number of proposals to consolidate the federal financial services regulatory structure. However, Congress has not reduced the number of federal financial services regulatory agencies for several reasons. First, the U.S. financial regulatory system has evolved into what some call a functional competitive regulatory structure where regulatory agencies compete against each other and there are regulatory redundancies. Yet, this structure may be viewed as fundamentally sound, despite periodic failures in regulatory enforcement.

Second, the regulation of financial services has become more complex. Since the Civil War, both the federal government and the states have regulated most financial services providers, such that they have some overlapping regulatory relationships. Financial providers began commingling financial services in the 1980s, a practice that contributed to regulatory enforcement failures. For example, banks no longer were exclusively providing banking services. Instead, insurance and securities companies also delivered banking services. When the federal government enacted the 1999 Gramm-Leach-Bliley Act (GLBA, P.L. 106-102), which repealed the law prohibiting the mixing of banking and commerce and allowed the commingling of financial services, the enforcement of financial regulation became more complicated. Analysts argued that regulators' inability to enforce safety and soundness requirements contributed to the financial crisis.

This report provides a brief history and overview of the U.S. federal financial services regulatory structure and examines the regulatory structural changes the three major federal government proposals would make to remedy the causes of the financial crisis. Specifically:

- The 2008 Paulson plan would have reduced the number of regulatory agencies to three by eliminating financial institutions' charters. Most depository institutions would have a national charter.
- The Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173), which would add a Financial Services Oversight Council, an independent Consumer Financial Protection Agency, and a Federal Insurance Office instead of consolidating agencies.
- The Restoring American Financial Stability Act of 2010 (RAFSA), which would consolidate and redistribute the regulatory responsibilities of bank holding companies by asset size among the three remaining bank regulators.

The report concludes with a discussion of some possible implications of reform. It will be updated as developments warrant.

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## Introduction

The purpose of this report is to examine the proposed changes to the U.S. financial services regulatory structure as the government tries to remedy the causes of the 2007-2009 financial crisis, given the structure's history of functional competitive regulation. The proposals are offered in three consecutive years around the crisis—the 2008 Secretary Henry Paulson Blueprint, the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173), and Senator Dodd's Restoring American Financial Stability Act of 2010 (RAFSA). The Paulson Plan argued that the financial services regulatory sector failed to enforce prudential requirements that would have kept the financial system safe and sound.<sup>1</sup> Financial services—banking, insurance, and securities trading—were no longer being provided exclusively by the designated regulated providers since the early 1980s. This weakened the enforcement of financial regulation as financial services regulation became more opaque. Banking services, for example, were no longer being provided exclusively by banks. Banking services were delivered by insurance and securities companies with little or no differentiation between providers.

Financial services companies were commingling products long before the federal government enacted the Gramm-Leach-Bliley Act of 1999 (GLBA, P.L. 106-102), which incorporated the framework of commingling financial services into U.S. financial services law. In the GLBA framework, the responsibilities of regulating financial institutions became more difficult to achieve because regulatory jurisdictions were less clearly defined. Financial services providers' activities have become more interrelated on the state and federal levels of government. Because providers were able to move risky assets off their balance sheets, a financial product such as mortgages could fall between the regulatory cracks. Such movement of assets undermines regulators' ability to determine accurately capital requirements for those risky assets.

The lack of regulatory clarity was helped by technological advances, which erased the traditional lines of demarcation in financial services products and services upon which the regulatory structure was built. With sophisticated trading models and advanced communications equipment, financial services regulators continued to lower barriers to bank entry into commodity futures and the options business. Technology and regulatory appeasement helped insurance to become a popular bank product.<sup>2</sup> Furthermore, as bankers' involvement in the securities business grew, the business itself began to change rapidly. As financial instruments or products became more complicated, the riskiness (probability of default) of the products became more difficult to determine for regulatory purposes. Maintaining a regulatory structure and control based on past market demarcations that have now slowly disappeared raised questions long before the 2007-2009 financial crisis about the effectiveness of the regulatory structure that has the responsibility for the safety and soundness of the financial firms under its jurisdiction. To some regulators, it was becoming clear that more regulatory coordination was increasingly necessary. The financial services councils and the consumer financial protection agency are being considered by Congress as additional regulatory agencies where responsibilities could be coordinated.

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<sup>1</sup>The Department of the Treasury, *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure*, March 2008, pp. 78-86.

<sup>2</sup> With the help of the Office of the Comptroller of the Currency and state banking regulators, national banks were able to expand their powers into the insurance business. See Meir Kohn, *Financial Institutions and Markets*, 1994, pp. 234-235.

This report is a brief overview of the U.S. federal financial services regulatory structure. The report centers around which regulator regulates which institution or product. It is not about how regulators supervise financial institutions, or how they regulate financial instruments. The report is divided into four sections. The first section is a brief overview of the major financial services regulators, a brief description of the regulatory structure on the state level of government, and a brief definition of safety and soundness, which is ultimately the main objective of financial regulatory agencies with examination authority. The second section provides the historical background that points out how bank failures marked financial crises and regulatory reforms as well as the functional, competitive regulatory reforms of banking, insurance, and securities, including commodities futures and options. The third section elaborates the difficulties of regulating in the current environment and examines the three major proposals to remedy the causes of the 2007-2009 financial crisis. The fourth section assesses the regulatory reform of consolidation of regulatory responsibilities and reassigning them to different regulators. The report concludes with some possible implications of the reform.

## **The Major Financial Services Regulators**

There are currently eight major federal regulators for the financial services industry. The following is a summary of the supervisory duties of the Office of the Comptroller of the Currency (OCC), the Federal Reserve System (the Fed), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC) and the Federal Housing Finance Agency (FHFA). All these agencies regulate for safety and soundness, although the SEC and the CFTC emphasize investor protection through disclosure.

### **The Office of the Comptroller of the Currency (OCC)**

As of September 30, 2009, the OCC is the regulator for approximately 1,465 nationally chartered banks, and the U.S. branches and offices of foreign banks. The OCC conducts on-site examinations of each national bank at least three times within every two-year period. The OCC does not receive any appropriations from Congress. It funds its operations primarily by assessments on banks it supervises and investment income from U.S. Treasury securities. These banks pay for examinations, application processing, and other services provided by the OCC.

### **The Federal Reserve System (Fed)**

The Fed supervises approximately 844 state-chartered commercial banks that are members of the system and 4,861 bank holding companies and financial holding companies. Along with the OCC, it also supervises some international activities of national banks. The Fed uses both on-site examination and off-site surveillance and monitoring in its supervision process. Each institution is examined on-site every 12 to 18 months. The Fed's in-house examiners are assigned to examine larger institutions continuously. The Board of Governors of the Fed coordinates the examination and compliance activities of the 12 regional Fed banks.

## **The Federal Deposit Insurance Corporation (FDIC)**

The FDIC regulates approximately 4,529 state-chartered commercial banks and 408 state-chartered savings associations that are not members of the Fed. The FDIC also insures deposits of the remaining 3,080 depository institutions without regulating them. The FDIC examines its supervised institutions approximately once every 18 months depending on the reported condition of the bank.

## **The Office of Thrift Supervision (OTS)**

The OTS supervises approximately 765 federally chartered savings associations, savings banks, and their holding companies. Like the OCC, the OTS is located within, but is independent of, the Treasury. The OTS is to conduct on-site examinations of each institution at least three times every two years.

## **The National Credit Union Administration (NCUA)**

The NCUA currently regulates 4,847 federally chartered credit unions and another 2,959 federal-insured state-chartered credit unions. Most credit unions are small and considered to have limited risk exposure. However, there are three multi-billion dollar credit unions. The NCUA regulates corporate credit unions, which are owned by credit unions and serve as the bankers of credit unions supplying liquidity and investment opportunities to credit unions.

## **The Securities and Exchange Commission (SEC)**

The SEC regulates to protect investors against fraud and deceptive practices in securities markets. It also has authority to examine institutions it supervises for compliance to its regulations. This covers securities markets and exchanges, securities issuers, investment advisers, investment companies, and industry professionals such as broker-dealers. The SEC supervises more than 8,000 registered broker-dealers with approximately 92,000 branch offices and 67,500 registered representatives.

## **The Commodity Futures Trading Commission (CFTC)**

The CFTC protects market users and the public from fraud and abusive practices in markets for commodity and financial futures and options. The CFTC delegates regulatory examinations to its designated self-regulatory organizations (DSROs), of which the most prominent are the National Futures Association (NFA), the Chicago Board of Trade, and the New York Mercantile Exchange. NFA membership covers more than 4,200 firms and 5,500 individuals. The regulatory process generally starts at registration, when the DSRO screens firms and individuals seeking to conduct futures business. The DSROs monitor business practices, and when appropriate, take formal disciplinary actions that could prohibit firms from conducting any further business.

## **The Federal Housing Finance Agency (FHFA)**

The FHFA was established in July 2008 with the mission to supervise, regulate, and oversee the government-sponsored-enterprises (GSEs), Freddie Mac and Fannie Mae. The GSEs are the

largest participants in the secondary mortgage market. The FHFA is also the regulator of the Federal Home Loan Banks (FHLB) that supplies funds to local lenders to finance home mortgages. FHFA is the regulator of the Department of Housing and Urban Development's (HUD's) activities to increase access to affordable housing and support community development free from discrimination. In 2008, the GSEs held \$6.6 trillion in assets and purchased 85% of all new mortgages. However, in that same year Fannie Mae and Freddie Mac became insolvent and are now in conservatorship under the Department of the Treasury.

## **State Financial Services Regulators**

State governments regulate most financial services providers including money services businesses, payday lenders, check cashing services, banks, insurance, securities trading, and mortgage financing firms. State regulation usually takes the form of licensing or chartering requirements before these firms are allowed to operate within the state. A large number of state chartered financial services providers are regulated on the federal level as well. The financial services providers may be grouped into one state commission or department. For example, a state financial services department may cover several kinds of financial services providers, or they may be separated by type of service. The banking commission may also regulate securities in a state. Usually, financial services commissions are headed by a financial services commissioner or department head. The financial services regulators in each state are charged with the execution of the state laws related to various financial services provided by financial institutions operating in that state. The department heads or commissioners are usually appointed by the governor. The department head is authorized to appoint deputies, examiners, and clerks as may be necessary to carry out the duties imposed on the state financial regulator by state law. State financial services regulators approve applications for charters from petitioners and have the power to terminate, liquidate, and distribute the assets of financial institutions that become bankrupt, as prescribed by state law. State examinations of financial service providers are for safety and soundness and consumer protection and could take place more frequently than twice a year if required. The expenses of the departments' services are usually paid for by assessments on the financial services providers.<sup>3</sup>

There are coordinating associations of state financial services regulators that help states homogenize policy among themselves while promoting competition. Some of the largest groups of regulators are the Conference of State Bank Supervisors (CSBS), the National Association of Insurance Commissioners (NAIC), and the North American Securities Administrators Association (NASAA).<sup>4</sup>

## **Safety and Soundness Regulations**

Financial regulators supervise banks either for safety and soundness or for disclosure. Safety and soundness regulations for depository institutions consist of basically five components: *federal deposit insurance* to reduce the likelihood of bank runs and panics; *deposit interest ceilings* to reduce the costs of bank deposits and weaken banks' incentives to invest in risky assets; *regulatory monitoring* to ensure that banks do not invest in excessively risky assets, have sufficient capital given their risk, have no fraudulent activities, and have competent management;

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<sup>3</sup> Glenn G. Munn, F.L. Garcia, and Charles J. Woelfel, *Encyclopedia of Banking and Finance*, 1994, pp. 79, 965.

<sup>4</sup> For more details see their websites: <http://www.csbs.org>, <http://www.naic.org>, and <http://www.nasaa.org>.



*capital requirements* to provide incentives for banks not to take excessive risk; and *portfolio restrictions* to prohibit investment in risky assets.

Under regulatory monitoring, U.S. banking regulators adopted a uniform rating system known as CAMELS to monitor banks' safety and soundness. "C" stands for capital adequacy, "A" stands for asset quality, "M" stands for management ability, "E" stands for earnings, "L" stands for liquidity, "S" stands for risk sensitivity. A composite CAMELS of 1 is very good, while a composite rating of 5 is very unsafe. The bank's capital is evaluated on the basis of the bank's size as well as the composition of its assets and liabilities, on and off the balance sheet. The quality of the bank's assets is determined by assessing the bank's credit risk of loans in its portfolio, which are classified as good, substandard, doubtful, or loss. Management ability is determined by evaluating the bank's management as well as its board of directors. The examiners assess competence, management acumen, integrity, and willingness to comply with banking regulations. Earnings are evaluated in terms of trends relative to the bank's peers. In determining the bank's liquidity, the examiners assess credit conditions, deposit volatility, loan commitments, and other contingent claims against the bank's capital, current stock of liquid assets, and the bank's perceived ability to raise funds on short notice. From the list of regulators above, one can see that bank examiners have overlapping jurisdictions. For example, national banks are also FDIC-Insured. Often federal and state examiners accept each others' examinations, and sometimes they examine jointly. It is important to note that it is illegal to disclose a bank examination (for example, CAMELS ratings) outside the bank.<sup>5</sup>

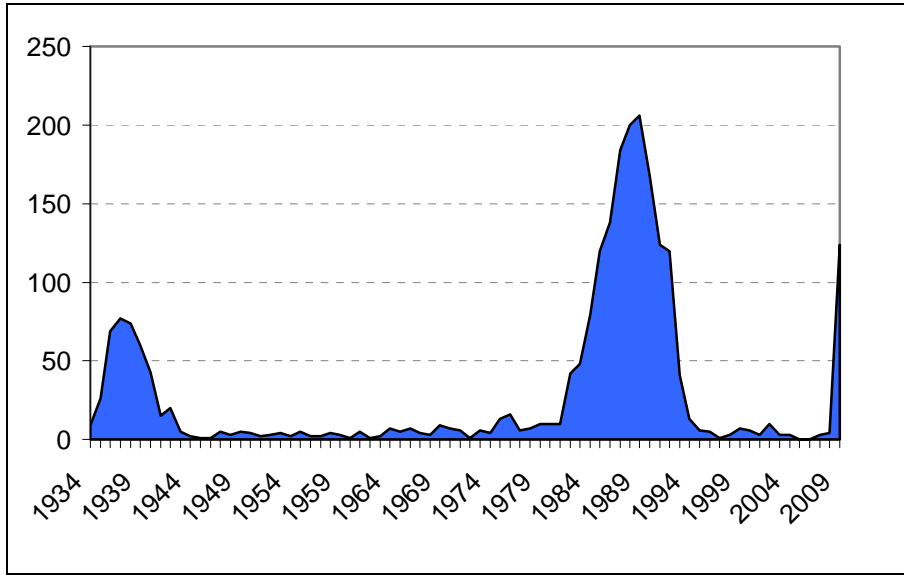
## Background

The timing of proposals to change the regulatory structure has often coincided with financial crises, which makes the number of bank failures a good indicator of when regulatory changes have taken place. **Figure 1** indicates that the numbers of bank failures rose in the 1930s after the stock market crashed in 1929 which was followed by runs of the banking system causing the rise in bank failures. It was not until the end of World War II that bank failures settled down. The regulatory reforms in the 1930s include the creation of the FDIC, the SEC, and the enactment of the Glass-Steagall Act that separated banking from commerce. These reforms were responsible for the decline in bank failures, which remained low until failures began rising in the 1980s during the Savings & Loan (S&L) crisis. Failures peaked in 1989. As shown in **Figure 1** and **Figure 2**, the peak in 1989 appears higher than in the 1930s because most of the bank failures in the 1930s occurred before the FDIC was created. **Figure 2** shows the ratio of the deposits of the failed institutions to the total deposits of FDIC-insured depository institutions (failed institutions' deposits divided by total deposits). In financial crises, smaller banks tend to fail before large ones as indicated by the number of bank failures peaking in 1989 with 206 failures, but the deposit of failed institutions peaked in 1991, when 124 institutions failed. A little more than 2% of the total banking deposits were held by these failed institutions in the S&L crisis. In contrast, at the end of 2006 no depository institution failed for the first time in two consecutive years since this data has been collected. But the subprime mortgage turmoil that started in August of 2007 and the credit crunch that followed contributed to the failure of three small banks in 2007, 25 in 2008, and 140 in 2009. The unprecedented federal government financial assistance to large banks dramatically reduced the total number of bank failure in the 2007-2009 financial crisis.

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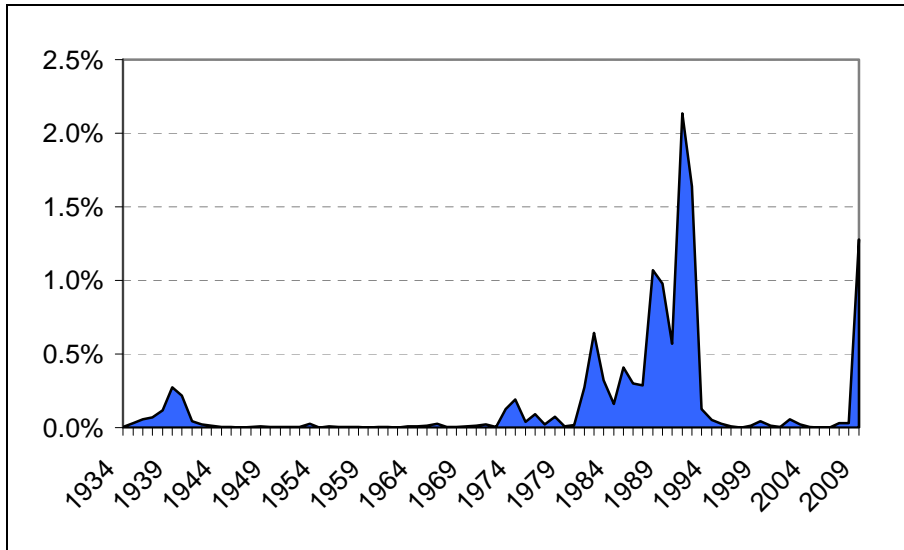
<sup>5</sup> See Stuart I. Greenbaum and Anjan V. Thakor, *Contemporary Financial Intermediation* (Orlando, FL: Dryden Press, 1995), pp. 514-521, or most finance textbooks.

**Figure 1. The Number of FDIC-Insured Bank Failures, 1934-2009**



Sources: FDIC 2007 Annual Report. Appendix A, p.107, and FDIC 2008 Failed Bank List, <http://www.fdic.gov/about/strategic/report/2004highlight/arhighlight.pdf>, and <http://www.fdic.gov/bank/individual/failed/banklist.html>.

**Figure 2. FDIC-Insured Bank Deposits: Ratio of Failed Bank Deposit to Total Bank Deposits, 1934-2009**



Sources: FDIC 2007 Annual Report. Appendix A, p.107, and FDIC 2008 Failed Bank List, <http://www.fdic.gov/about/strategic/report/2007highlight/arhighlight.pdf>, and <http://www.fdic.gov/bank/individual/failed/banklist.html>.

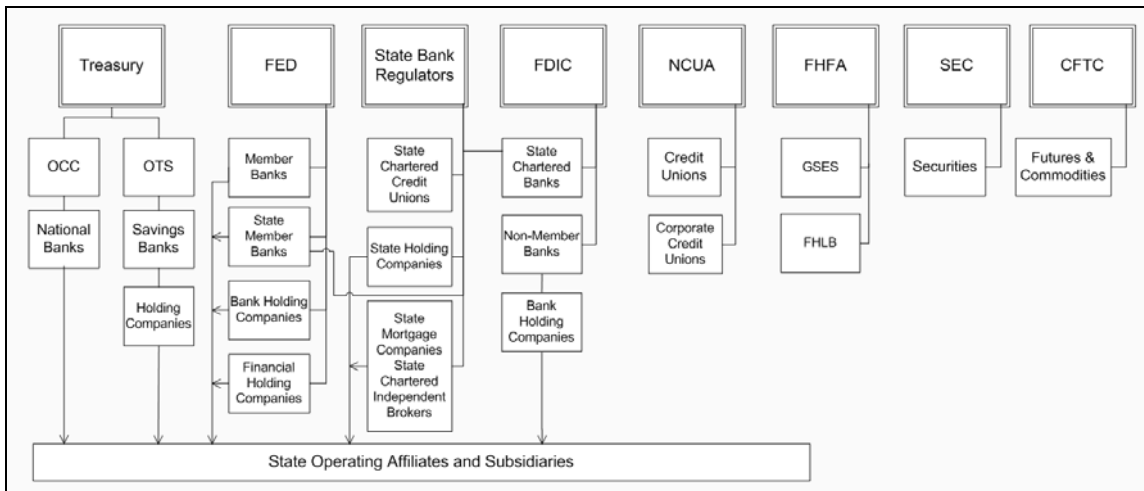
## U.S. Dual Regulatory Financial Structure

Since the mid-1990s, the United States has resisted proposals to consolidate its federal financial services regulators into a single regulator as many of its industrial trading partners have done.<sup>6</sup>

<sup>6</sup> GAO, *Financial Markets Regulation: Agencies Encouraged in Consolidated Supervision Can Strengthen* (continued...)

One reason is that many of these proposals have not fully figured out how to consolidate the complex dual financial services regulatory structure. The state regulatory system is intertwined with the federal system as shown in **Figure 3** for depository institutions. Other financial services not shown in **Figure 3** are similarly intertwined in different ways on the state and federal level of government. Securities firms are regulated differently from banks on both levels of government. For depository institutions, state chartered or licensed institutions are federally regulated if those depository institutions purchase FDIC deposit insurance, or become members of the Federal Reserve. The Federal Reserve and the OTS regulate state chartered bank and financial holding companies. Credit unions have a similar structure as banks, because federal credit unions are insured by the National Credit Union Administration. Some credit unions are chartered by states and are regulated on the state level only, because their deposits are not federally insured by the NCUA. A national bank in a holding company is regulated by the Federal Reserve and the OCC, which is different from the OTS regulation of its relatively large thrift holding companies. In securities institutions the regulatory requirements are focused on the institutions as well as the individuals providing the financial services or selling the financial products. Consequently, investment advisers and dealer-brokers are required to register on the state level as well as with the SEC on the federal level.<sup>7</sup>

**Figure 3. U.S. Financial Services Regulatory Structure**



**Sources:** CRS and The Department of the Treasury, *Blueprint for a Modern Financial Regulatory Structure*, March 2008. p. 207.

## U.S. Functional and Competitive Regulatory Structure

The federal regulatory structure is arguably said to be functional and competitive because regulators supervise institutions by their line of business or function, such as banking, insurance products, or securities trading.<sup>8</sup> The structure is said to be competitive because there are usually

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*Performance Measurement and Collaboration*, GAO-07-154 (Washington, DC: March 15, 2007).

<sup>7</sup> Melanie L. Fein, "Functional Regulation: A Concept for Glass-Steagall Reform," *Stanford Journal of Law, Business & Finance*, Spring 1995, pp. 89-90; and Jerry W. Markham, *Banking Regulation: Its History and Future* (Chapel Hill, NC: North Carolina Banking Institute, 2000), pp. 277, 285.

<sup>8</sup> See FDIC Chairman Donna Tanoue's Testimony on Financial Modernization, before the U.S. Senate Committee on (continued...)

multiple regulators responsible for a single function.<sup>9</sup> Regulatory responsibilities are widely dispersed among several regulators on the federal and often on the state level of government as well. The structure allows regulations to be tailored to the specific deficiencies at the appropriate level of the abusing firm(s) or individuals. Also, the structure promotes innovations and competition among financial services providers. Opponents argue that the overlapping regulations are costly and allow astute financial services firms to exploit weaknesses along the regulatory seams. The structure also allows financial services providers to shop for the regulator that best suits their business plan. This was confirmed in a FDIC survey that showed that the top reasons given by the 34 banks that changed their charter to the FDIC were that “the FDIC was less expensive and more banker friendly, and that other regulators were stricter, and that institutions could more readily pursue market share increases.”<sup>10</sup> On the other hand, the ability to shop for regulators could lead to more institutions being regulated by the weakest regulators, which would increase systemic risk. RAFSA, the Senate proposal, addresses this systemic risk exposure in the context of regulating bank holding companies.<sup>11</sup> The following sections provide a brief history of regulatory competition in the major financial services.

## **Regulatory Competition in Banking**

In the beginning of the nation, the federal government exercised an indirect role in the regulation of banking through the First and Second Banks of the United States. When President Andrew Jackson refused to renew the Second Bank’s charter, states’ regulatory banking commissions filled the regulatory vacuum that was created.<sup>12</sup> The Civil War and the disarray of the national currencies led to the reintroduction of the federal government into regulating banks by establishing the national bank charter system, which was governed by the Comptroller of the Currency (OCC) established in 1863.<sup>13</sup> Its creation immediately began the dual banking system which exists today and placed the federal government in competition with states for the number and size of banks under their respective jurisdictions. Until about four decades ago, most bankers preferred state charters because states’ regulations were considered less burdensome.

More layers to the regulatory structure, and therefore competition between regulators, were added with the creation of the Federal Reserve Board after the Panic of 1907 and the creation of the Federal Deposit Insurance Corporation (FDIC) after the banking failures of the Great Depression in the 1930s. Further layers of regulatory competition were added when saving banks and credit unions were provided with separate federal regulators which evolved into the Office of Thrift

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Banking and Urban Affairs, June 25, 1998, <http://www.fdic.gov/news/news/speeches/archives/1998/sp25june98.html>; The Department of the Treasury, *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure*, March 2008, p. 27; and *Restoring American Financial Stability Act of 2010*, section 1091, p. 1268.

<sup>9</sup> Bert Ely, “Functional Regulation Flunks: It Disregards Category Blurring,” *American Banker*, February 27, 1997, p. 4.

<sup>10</sup> BNA Banking Report, “Bank Supervision ‘Burdensome’ Regulations Complaint In FDIC Ombudsman Surveys, Agency Says,” *BNA’s Banking Report*, March 28, 2005, p. 1, at <http://www.fdic.gov/regulations/resources/ombudsman.html>.

<sup>11</sup> See *Restoring American Financial Stability Act of 2010*, section 604, p. 429.

<sup>12</sup> Jerry W. Markham, *Banking Regulation: Its History and Future* (Chapel Hill, NC: North Carolina Banking Institute, 2000), pp. 226-227.

<sup>13</sup> National Bank Act of 1863, ch. 106, 13 stat. 99.

Supervision (OTS) and the National Credit Union Administration (NCUA).<sup>14</sup> The Great Depression also led Congress to pass the Glass-Steagall Act of 1933 (Ch.89, 48 Stat.162) to further seal off banking from other financial services enterprises by prohibiting banks from engaging in investment banking activities until it was repealed by the Gramm-Leach-Bliley Act of 1999 (GLBA) (P.L. 106-102). GLBA repealed the Glass-Steagall Act, allowing financial companies owning or operating institutions to commingle financial services.

## **Regulatory Competition in Insurance**

Like banking, the insurance industry owes its competitive regulatory structure to correcting deficiencies. States began regulating insurance in 1837, starting with Massachusetts and New York, to ensure that insurance companies maintained adequate reserves to meet claims.<sup>15</sup> In the early 1920s, states significantly increased legislative restrictions on insurance companies, starting in New York and copied by other states. A New York legislature's investigation uncovered massive insurance companies' abuses that left them without adequate reserves to pay claims. That led to the New York state's legislature passing laws barring companies from underwriting insurance while underwriting other securities.

Copying New York state's regulations, states separated insurance companies from the banking industry.<sup>16</sup> These regulatory provisions also protected the insurance industry from the excesses of the securities industry in the late 1920s that led to the stock market crash. Consequently, when the stock market crashed in 1929, the insurance companies were relatively sound financially.<sup>17</sup> Having escaped the massive failures of the other parts of the financial services sector, the insurance companies were not included in New Deal regulatory legislation, even though in 1934 the Securities and Exchange Commission (SEC) proposed a federal agency to regulate insurance companies. The proposal was soundly rejected upon objections from the industry and state regulators.<sup>18</sup>

Another possible expansion of federal regulation of insurance came in 1944 from a Supreme Court ruling which held that the insurance industry was subject to the federal antitrust laws.<sup>19</sup> The insurance industry feared that this ruling would preempt their state regulation. As a result, the industry lobbied Congress heavily to pass the McCarran-Ferguson Act, which granted insurance companies immunity from the antitrust laws to the extent that they were regulated by state insurance laws.<sup>20</sup> The McCarran-Ferguson Act protected the insurance industry until the early 1950s when insurance companies began selling variable annuities, which the SEC challenged. The SEC argued that variable annuities were securities subject to its regulation because the returns on these investments were based on investment of the annuitants' premium payments in

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<sup>14</sup> Broome and Markham, *Regulation of Bank Financial Service Activities* (New York: West Publishing, 2001), pp. 78-81, 87.

<sup>15</sup> Broome and Markham, "Banking and Insurance: Before and After the Gramm-Leach-Bliley Act," *Journal of Corporation Law*, Summer 2000, p. 727.

<sup>16</sup> *Ibid.*, p. 731.

<sup>17</sup> Temporary National Economic Committee (TNEC), *Investigation of the Concentration of Economic Power*, Monograph No. 28A: Statement on Life Insurance, 76<sup>th</sup> Congress, 2<sup>nd</sup> sess., 1941, pp. 2, 107.

<sup>18</sup> Broome and Markham, "Banking and Insurance: Before and After the Gramm-Leach-Bliley Act," p. 732.

<sup>19</sup> *United States v. South-Eastern Underwriters Association*, 322 U.S. 533 (1944).

<sup>20</sup> Jerry W. Markham, "Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan," *Brooklyn Journal of International Law*, 2003, p. 4.

securities. The Supreme Court found for the SEC. Insurance companies selling variable annuity contracts are now regulated by states and the SEC.<sup>21</sup>

The insurance industry was able to stave off other federal intrusions, despite suffering significant losses from contracts sold in the 1980s.<sup>22</sup> The industry, however, could not avoid competition from the banking and securities industries.<sup>23</sup> One reason was that variable annuities became a growing line of financial services products sold by stockbrokers. In addition, federal bank regulators began allowing banks to sell insurance products in the 1990s.<sup>24</sup> This competition resulted in many insurance companies demutualizing<sup>25</sup> and expanding their own financial service offerings, such as more securities-like products with banking services options.<sup>26</sup> In sum, even though regulatory competition was maintained with the states, state insurance regulators could not protect insurance companies from competition from other financial services providers. There have been several legislative proposals in recent years to impose federal regulation on some companies who offer securities-like products with banking services options.<sup>27</sup>

## Regulatory Competition in Securities

When the Securities and Exchange Commission was created by Congress in 1934—in the wake of the stock market crash of 1929—it was to establish a strong federal regulatory presence in the market for corporate securities.<sup>28</sup> The SEC's main focus was full disclosure in the securities markets. The Securities and Exchange Act of 1934 did not preempt state securities regulations. Consequently, the SEC has competed with state securities regulators for most of its existence.<sup>29</sup> With the exception of mortgage-backed securities in 1984, it was not until the National Securities Markets Improvement Act of 1996 that some of the states' securities regulations were preempted or states were required to conform their standards to those of the SEC.<sup>30</sup> Federal securities law and SEC regulations apply to the markets where securities are traded and to all businesses that sell stocks or bonds to public investors. Other regulated entities include mutual funds, bidders in corporate mergers and acquisitions, certain investment advisers, public accountants, and power

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<sup>21</sup> Broome & Markham, "Banking and Insurance: Before and After the Gramm-Leach-Bliley Act," p. 737.

<sup>22</sup> *Ibid.*, p. 739.

<sup>23</sup> Cedric V. Fricke, *The Variable Annuity: Its Impact on the Savings-Investment Market*, Bureau of Business Research, School of Business Administration, University of Michigan, 1959, 90 p.

<sup>24</sup> For example, states were unable to restrict banks from selling insurance following banks' victories in the courts. See *U.S. National Bank of Oregon v. Independent Agents of Agents of America*, 508 U.S. 439 (1993), and *Barnett Bank of Marion County N.A.B. Nelson*, 517 U.S. 25 (1996).

<sup>25</sup> Many insurance companies changed from being owned by their customers to publicly owned companies. See Broome & Markham, "Banking and Insurance: Before and After the Gramm-Leach-Bliley Act," pp. 19, 745-746.

<sup>26</sup> See CRS Report RL32138, *Revising Insurance Regulation: Policy Considerations*, by Baird Webel and Carolyn Cobb.

<sup>27</sup> See U.S. Congress, Senate Committee on Commerce, Science, and Transportation, *Federal Involvement in the Regulation of the Insurance Industry*, hearing, 108<sup>th</sup> Cong., 1<sup>st</sup> sess., October 22, 2003, available at <http://www.commerce.senate.gov>.

<sup>28</sup> Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (New York: Aspen Publishing, 1995), p. 45.

<sup>29</sup> Jerry W. Markham, "Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan," *Brooklyn Journal of International Law*, 2003, p. 4.

<sup>30</sup> *Ibid.*, p. 34.

utilities (the SEC has some control over the market structure under the Public Utility Holding Company Act of 1935).<sup>31</sup>

In this securities regulatory structure, regulatory competition remains in the form of self-regulatory organizations (SROs). These are non-governmental organizations that were given regulatory authority and shelter from the antitrust laws by the Securities and Exchange Act of 1934.<sup>32</sup> SROs like the securities exchanges and the National Association of Securities Dealers, Inc. (NASD) are required to regulate the conduct of their members. The SEC's role is to oversee the exchanges, as well as act directly when the SROs' oversight fails.<sup>33</sup>

In addition to the SROs, the structure of securities regulation also includes accountants that certify the financial statements of public companies and broker-dealers as well as the Nationally Recognized Statistical Ratings Organizations (NRSROs). The NRSROs include rating agencies such as Moody and Standard & Poor's. The SEC's ability to enforce its rules over accountants and broker-dealers has been strengthened by the Sarbanes-Oxley Act of 2002, which created a Public Company Accounting Oversight Board to oversee the auditing principles of auditors. Sarbanes-Oxley also requires the SEC to conduct a study of NRSROs and to report to Congress on any deficiencies. Concerns about conflict of interest and certification have resulted in the Senate Committee on Banking, Housing, and Urban Affairs holding hearings on the regulation of NRSROs.<sup>34</sup> In 2006, Congress enacted the Credit Rating Agency Act of 2006, which specifically gave the SEC more regulatory control over NRSROs. However, a number of analysts believe that NRSRO poor performance and failure to do due diligence in rating securities contributed to the 2007-2009 financial crisis.<sup>35</sup>

## **Regulatory Competition in Commodity Futures and Options**

Like the other financial services, commodities futures were separated from the rest of the industry as part of historical regulatory evolution in the United States. The agricultural recession of 1921 following World War I, and speculative manipulation of commodity prices prompted Congress to pass the Grain Futures Act of 1922 under its commerce powers.<sup>36</sup> The Grain Futures Act required commodity futures trading to be conducted on organized exchanges, such as the Chicago Board of Trade, which would register with the government as contract markets. With commodity speculation and market manipulation unchecked in the Great Depression, President Roosevelt added regulation of the commodity markets to his request for regulation of the securities market. Congress responded with the Commodity Exchange Act of 1936 (CEA), which continued many

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<sup>31</sup> See the Securities and Exchange Commission section by Mark Jickling in CRS Report RL32309, *Appropriations for FY2005: Commerce, Justice, State, the Judiciary, and Related Agencies*, by Ian F. Fergusson and Susan B. Epstein.

<sup>32</sup> Self-regulation by the National Association of Securities Dealers was added in 1938 by the Maloney Act, 52 Stat. 1070 (Codified as amended at 15 U.S.C. § 780-3 (2000)).

<sup>33</sup> Jerry W. Markham, "Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan," p. 5.

<sup>34</sup> Alec Klein, "Debt-Rating Firms Resist Prospect of More Supervision" *The Washington Post*, February 9, 2005, p. E-2. For testimonies presented at the Senate hearing, see <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=136>.

<sup>35</sup> CRS Report R40613, *Credit Rating Agencies and Their Regulation*, by Gary Shorter and Michael V. Seitzinger.

<sup>36</sup> The Futures Trading Act of 1921, Ch. 86, 42 Stat. 187 (1921) was found unconstitutional by the Supreme Court as an impermissible use of the congressional taxing powers. See Jerry W. Markham, "Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan," *Brooklyn Journal of International Law*, 2003, p. 7.

of the requirements of the Grain Futures Act, but required futures commission merchants (the equivalent to broker-dealers in the securities business) to register with the government.<sup>37</sup>

For decades, even though options trading of regulated commodities, and manipulation of commodity prices, were prohibited, the government was unable to stop speculation and manipulation in commodity prices, particularly in options on unregulated commodities which added to the rapid rise in commodity prices in the early 1970s. The Commodity Futures Trading Commission Act of 1974 was enacted in response to developments in the commodities markets which carried forward the Commodity Exchange Act and created the CFTC.<sup>38</sup>

The CFTC was given exclusive jurisdiction over the trading of commodity futures and providing it with commodity options on all commodities, more enforcement powers than its predecessor. Its regulatory reach included commodity trading advisors, commodity pool operators, and associated persons of futures commission merchants.<sup>39</sup> Despite the increased federal regulation of the commodity trade, the regulatory control of commodity trade remained less stringent than SEC's control of trade in securities. Competition between the SEC and the CFTC developed when the financial services industry began developing new financial instruments and trading strategies that converged on products regulated by both regulators—stock index futures, and other equity-based derivatives. The difference in the level of regulation in the securities and the commodity futures and options markets became important to investors. Over-the-counter (OTC) instruments such as swaps, caps, collars, and floors were increasingly popular alternatives to exchange-traded commodity futures and options. Some of these instruments were abused by both SEC- and CFTC-regulated firms and traders. In 1978, Congress mandated that the two agencies consult with each other and with banking regulators in curtailing these abuses.<sup>40</sup>

During the 1980s and 1990s, the over-the-counter market for financial derivatives was the source of regulatory competition between the CFTC and the banking regulators—the Fed and the OCC. The banking regulators argued for no regulation of OTC financial derivatives, even though Congress had given the CFTC exclusive jurisdiction over all contracts and mandated that all such contracts be traded on CFTC-regulated exchanges. However, the CFTC did not move to assert its regulatory jurisdiction over these derivative contracts. The lack of regulation provided a legal risk to swaps contracts. That is, if a court had ruled that swaps were illegal, trillions of dollars in OTC derivative contracts might have been rendered void and unenforceable.<sup>41</sup> While the harmonization of SEC and CFTC oversight of derivative products is a goal, it has not been reached throughout the 2007-2009 financial crisis.<sup>42</sup> Regulating the OTC derivatives market continues to be a contentious issue in the regulatory reform debate in Congress.

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<sup>37</sup> *Ibid.*, pp. 7-8.

<sup>38</sup> Jerry W. Markham, "Manipulation of Commodity Futures Prices—The Unprosecutable Crime," *Yale Journal on Regulation*, vol. 8, 1991, p. 281.

<sup>39</sup> Jerry W. Markham, *History of Commodity Futures Trading and Its Regulation* (New York: Praeger, 1987), pp. 66-72.

<sup>40</sup> *Ibid.*, pp. 99-100.

<sup>41</sup> CRS Report RS20560, *The Commodity Futures Modernization Act (P.L. 106-554)*, by Mark Jickling.

<sup>42</sup> CRS Report R40646, *Derivatives Regulation in the 111<sup>th</sup> Congress*, by Mark Jickling and Rena S. Miller.



## The Problem of Regulating in the Current Environment

As mentioned above, the GLBA framework added to the opaqueness of the responsibilities to regulating financial institutions. The regulators no longer have the separation of the lines of businesses—banking, insurance, and investing in securities—that they had in the past. Technological advances helped to erase the traditional lines of financial services and products upon which the regulatory structure was built. Bank regulators, knowing the technical capacity of banks, have lowered barriers to bank entry into commodity futures, options, and proprietary trading businesses, and insurance has become a popular bank product. As bankers got more involved in the securities business with derivatives, the overall business had began changing rapidly. Maintaining a regulatory structure and control rooted in past established market behavior that is rapidly disappearing raises the question of what are the appropriate tools financial regulators need to more effectively manage changing risks.

Pin pointing regulatory enforcement became increasingly difficult. To illustrate with the help of **Figure 3**, national banks, which are regulated by the Office of the Comptroller of the Currency, were able to establish nonbank state operating affiliates and subsidiaries to conduct most of their mortgage lending. While the national banks' books indicated to the OCC that they were fully in compliance with the OCC's capital requirements, those books did not fully reflect the riskiness of the assets the national banks had in their state-regulated affiliates and subsidiaries. It was only when the losses due to bad mortgages held by state nonbank affiliates and subsidiaries had to be reported on the consolidated balance sheets of the national banks that regulators realized that these national banks were severely undercapitalized.<sup>43</sup> Finding a solution to these developments comes through the familiar pattern of regulatory changes occurring only after the risks have risen sufficiently to bring about significant losses that reveal the deficiencies in the structure.

## Proposed Solutions<sup>44</sup>

### The 2008 Henry Paulson Blueprint for a Modernized Regulatory Structure

The first major proposal in the debate on how best to remedy the deficiencies revealed in the 2007-2009 financial crisis was the *Department of the Treasury Blueprint for a Modernized Regulatory Structure* (the Blueprint). It was motivated by the Bush Administration's recognition that the existing functional regulatory framework no longer provides efficient and effective safeguards against poor prudential behavior of financial services firms.<sup>45</sup> The Administration

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<sup>43</sup> The problem could be avoided if banks balance sheets were consolidated. See Steven Marcy, "Determining Control the Big Challenge in FASB Consolidation Rules, Panelists Say," *BNA Banking Daily*, November 4, 2009, p. 1, [http://news.bna.com/bdln/BDLNWB/split\\_display.adp?fedfid=15714483&vname=bbdbulallissues&wsn=502480000&searchid=10986402&doctypeid=1&type=date&mode=doc&split=0&scm=BDLNWB&pg=0](http://news.bna.com/bdln/BDLNWB/split_display.adp?fedfid=15714483&vname=bbdbulallissues&wsn=502480000&searchid=10986402&doctypeid=1&type=date&mode=doc&split=0&scm=BDLNWB&pg=0); and Thecla Fabian, "FDIC OKs Risk-Based Capital Rule; Seeks Feedback on Failed Bank Securitizations," *BNA Banking Daily*, December 16, 2009, p. 1, [http://news.bna.com/bdln/BDLNWB/split\\_display.adp?fedfid=15844516&vname=bbdbulallissues&wsn=501578000&searchid=10986402&doctypeid=1&type=date&mode=doc&split=0&scm=BDLNWB&pg=0](http://news.bna.com/bdln/BDLNWB/split_display.adp?fedfid=15844516&vname=bbdbulallissues&wsn=501578000&searchid=10986402&doctypeid=1&type=date&mode=doc&split=0&scm=BDLNWB&pg=0).

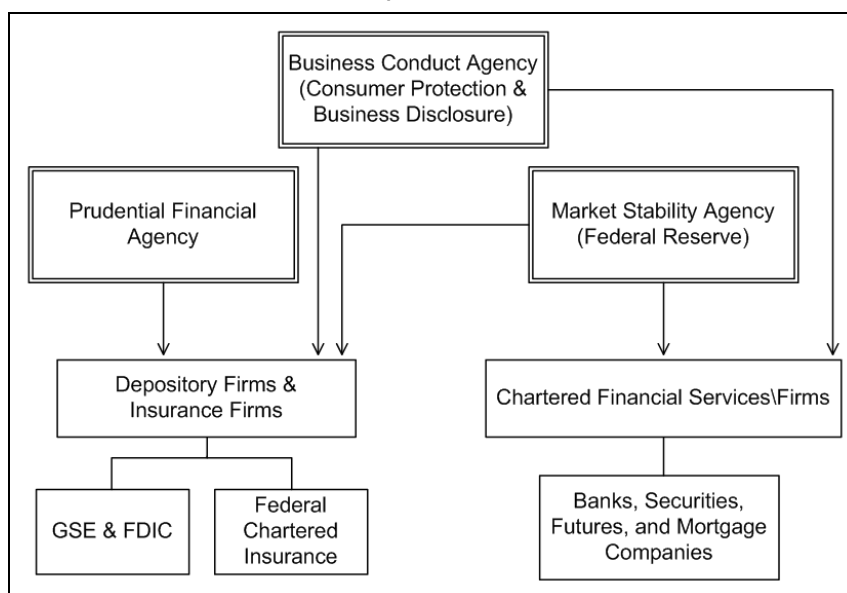
<sup>44</sup> There are a number of non-U.S. government proposals that were not discussed in this report, such as the ones offered by the Group of Thirty in *The Structure of Financial Supervision Approaches and Challenges in a Global Market Place*, 2008, 248 p. Only the three U.S. government proposals were considered.

<sup>45</sup> The Department of the Treasury, *The Department of the Treasury Blueprint for a Modernized Financial Regulatory* (continued...)

believed that the existing framework is based on a structure that was largely knitted together over 75 years to address specific economic disruptions. According to the Bush Administration in the Blueprint, the structure is not optimal any more because financial institutions have become more opaque and more difficult to understand as the institutions develop new products and complex risk-hedging strategies that are difficult to evaluate.

**Figure 4. The Treasury’s Blueprint for a Modernized Regulatory Structure**

Henry Paulson Plan



**Source:** The Department of the Treasury, *Blueprint for a Modern Financial Regulatory Structure*, March 2008, p. 144.

For these reasons, on March 31, 2008, Treasury Secretary Henry Paulson offered the Blueprint as a more optimal federal financial regulatory structure. This proposed framework would consolidate similar functions rather than consolidate agencies by renaming existing regulatory agencies and make significant changes in their responsibilities. The plan proposed three major regulatory agencies: *a market stability regulator*, which would serve as the monetary and lender of last resort functions of the Federal Reserve; *a prudential regulator*, which would write and enforce the safety and soundness prudential laws and regulations that are shared by all existing regulators; and *a business conduct regulator*, which would serve as a consumer and business protection regulator whose functions are now shared by all regulators and particularly the SEC and the CFTC.

U.S financial services would be regulated on the federal level of government. Financial services would be divided into two groups. One group would be depository firms and insurance firms, which would include the government sponsored enterprises (GSEs) and the FDIC-insured depository institutions. The other group would be chartered financial services firms. These institutions would be regulated by their charters, which include banks, securities, and futures firms, as well as mortgage companies.

(...continued)

*Structure*, March 2008, 218 p.

The Paulson plan would have resulted in a consolidated structure outlined in **Figure 4**, but it does not fully explain how the existing structure would be converted into the final structure shown in **Figure 4**. Consequently, the financial services industry's reaction to the Blueprint has been mixed with the criticisms outweighing the support of the proposal.<sup>46</sup> Banking groups supported the prospects of regulatory modernization, but were critical of the Blueprint's plan to eliminate the thrift and credit union charters along with their supervisory agencies—the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA). On the other hand, the mortgage bankers supported the Blueprint arguing that it would lead to resolving regulatory inconsistencies in mortgage lending supervision at the state level. For insurance, most smaller insurance companies opposed the Blueprint's optional federal charter, which would give insurance companies the option of federal regulation rather than the existing state regulation of insurance companies. By contrast, large insurance companies operating in several states supported the optional federal charter proposal, while state insurance commissions were quick to oppose the Blueprint's insurance proposal. The commissioners argue that they support needed modernization but that does not mean federalization. On the securities and futures markets, the Blueprint proposes to merge the SEC with the CFTC, which has been proposed before but has not happened. In short, the Blueprint would have eliminated significant parts of the existing regulatory structure, and failed to convince stakeholders in the existing structure that the replacement would be an improvement. The congressional plans below take a different tack. Instead of consolidating regulatory agencies, they consolidate regulatory responsibilities.

## **The Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173)**

The Wall Street Reform and Consumer Protection Act (H.R. 4173) that was passed by the House of Representatives on December 11, 2009, would only minimally consolidate the financial services regulatory agencies. Instead of increased transparency and accountability, the overall thrust of H.R. 4173 is to consolidate specific financial regulatory responsibilities (that the framers determined to be important) into specific agencies resulting in an expansion of the number of federal financial services regulatory agencies. By comparing **Figure 1** with **Figure 5**, there would be three new federal regulatory agencies in **Figure 5**: the Financial Services Oversight Council (FSOC), the Consumer Financial Protection Agency (CFPA), and the Office of National Insurance (ONI). Most of the duties of these new agencies would be dispersed throughout the current structure.

### **The Financial Services Oversight Council (the Council)**

The purpose of the Council is to oversee systemic risk, advise Congress, develop strategies to prepare for potential threats to the stability of the U.S. financial system, and identify systemically important companies and activities in consultation with the Federal Reserve and primary financial regulatory agencies. The Council is chaired by the Secretary of the Treasury. It includes representatives from regulatory agencies under the Secretary of the Treasury: OCC chairman and OTS chairman. Other members of the Council shown in **Figure 5** are the SEC chairman, CFTC

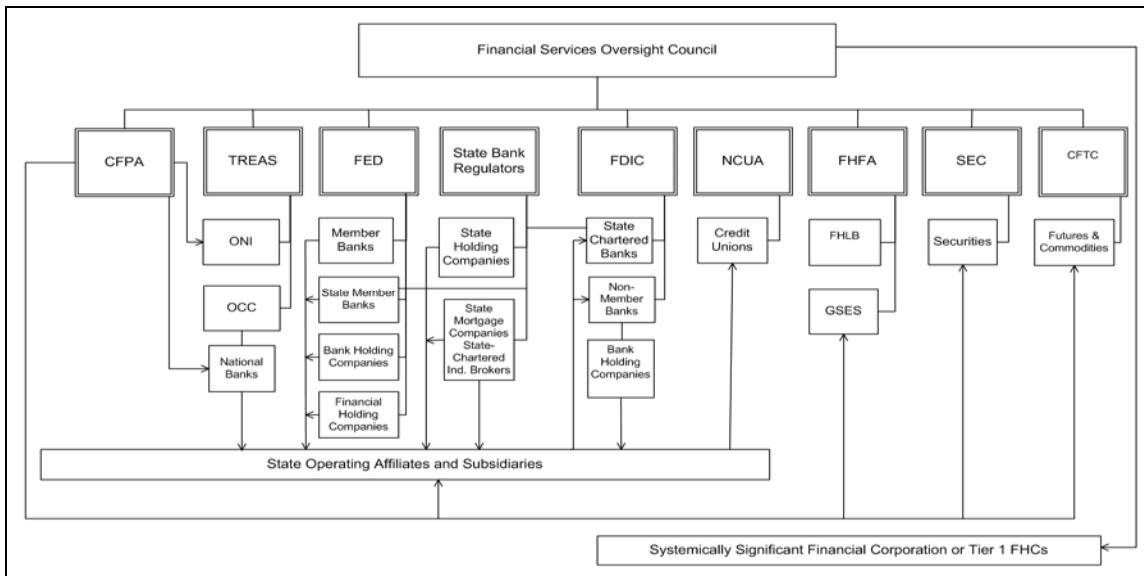
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<sup>46</sup> Richard Cowden, Thecla Fabian, and Marcia Kass, "Banking Industry's Reactions to Blueprint Suggest a Mixture of Support, Reservations," *BNA Banking Daily*, April 1, 2008, p. 1, [http://news.bna.com/bdln/BDLNWB/split\\_display.adp?fedfid=7014368&vname=bbdbulallissues&wsn=514134000&searchid=10987711&doctypeid=1&type=date&mode=doc&split=0&scm=BDLNWB&pg=1](http://news.bna.com/bdln/BDLNWB/split_display.adp?fedfid=7014368&vname=bbdbulallissues&wsn=514134000&searchid=10987711&doctypeid=1&type=date&mode=doc&split=0&scm=BDLNWB&pg=1).

chairman, CFPB chairman, FED chairman, FDIC chairman, NCUA chairman, FHFA director, and the ONI to be created. All primary federal financial services regulators are agents of the Council with respect to systemic risk regulation. Systemically important firms would be supervised by the Council as a whole. The other non-voting members are a state banking supervisor, a state insurance commissioner, and a state securities commissioner. However, only the state insurance authorities would be treated as a primary regulator.

The Council has dissolution authority for systemically important firms whose imminent or actual default would have serious adverse effects on the financial stability or economic conditions of the United States. The proposal prescribes procedure under which the Secretary of the Treasury could appoint the FDIC as receiver for one year to resolve, liquidate, or take other specified emergency stabilization actions. The Council is responsible for indentifying and applying stricter prudential regulation to systemically important firms such as risk-based capital, which their regulators must seek to make countercyclical. The Council is mandated to enforce leverage limits not to exceed 15 to 1 by statute, and a credit concentration limit of 25% (which means that a single counterparty would be limited to 25% of its capital stock). Systemically important firms could be treated differently from one another. If a systemically important firm poses a grave threat to the economy, the council has considerable powers to take action. The Council has the power to sell a systemically important firm’s assets or break up the firm. The Council can require a quarterly stress test, and the results must be publicly announced. The Council has the authority to force the systemically important firm to provide a living will (failure liquidation plan) that must be periodically updated, and the company must report its plan to the Federal Reserve and the FDIC.

**Figure 5. The Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173)**



Source: Congressional Research Service.

### The Consumer Financial Protection Agencies (CFPA)

As an independent agency, the CFPB would regulate the provisions of consumer financial products and services. The CFPB would consolidate, by transfer, much of the consumer financial protection functions of the Federal Reserve Board, the Office of Comptroller of the Currency, the Office of Thrift Supervision, the FDIC, the Federal Trade Commission, the NCUA and the

Secretary of Housing and Urban Development (HUD). The CFPA would examine banks and credit unions with assets of over \$10 billion as well as other financial services providers. The safety and soundness regulators would have primary examination and enforcement authority over banks, thrifts, and credit unions with assets less than \$10 billion. The CFPA is mandated to develop risk-based programs to supervise non-depository covered individuals who provide consumer financial products and services, and take actions to prohibit unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer, or any offering of a consumer financial product or service. Not covered by the CFPA are any individuals regulated by the SEC, the CFTC, or a state securities commission, which would include broker-dealers and most investment and financial advisers, but only to the extent that such individuals “act in a registered capacity.” Other entities that would be excluded from certain aspects of the CFPA authority include insurance companies; sellers of goods or services who extend purchase money credit; auto dealers; accountants, tax preparers, and attorneys; real estate licensees; and employee benefit plans. The CFPA has the authority to prescribe standards for federal preemption of states’ protection laws regarding national banks and subsidiaries and federally chartered thrifts.

### **The Office of National Insurance (ONI)**

As mentioned above, H.R. 4173 would create the ONI in the Department of the Treasury with the Secretary of the Treasury appointed the Director of the ONI who is an advisor to the Financial Services Oversight Council. The duties of the ONI are to monitor the insurance industry and identify gaps; recommend to the Council any insurers that should be treated as systemically important; assist in administering the Terrorism Insurance Program; represent the U.S. in overseas forums such as the International Association of Insurance Supervisors; and to determine whether state insurance measures are preempted by international agreements. The ONI must report to Congress on modernization and improving U.S insurance regulation and the role of the global reinsurance market in support of insurance in the United States.

### **The Restoring American Financial Stability Act (RAFSA) of 2010**

**Figure 6** shows that there are significant differences between H.R. 4173 and RAFSA, Senator Dodd’s proposal that was reported out of the Committee on Banking, Housing, and Urban Affairs on March 22, 2010.<sup>47</sup> Since Senator Chris Dodd, chairman of the Committee on Banking, Housing, and Urban Affairs, unveiled a draft of his financial regulatory reform bill, certain provisions have been controversial. The bill’s sharpest contrast with H.R. 4173 is that the *Restoring American Financial Stability Act* would redistribute federally regulated depository institutions among the three major federal regulators—the Federal Reserve, Office of the Comptroller, and the FDIC. Unlike H.R. 4173, RAFSA excludes the National Credit Union Administration and the state financial services regulators from being voting members of the council. The Fed is already on record criticizing the proposal for restricting its regulation to financial services companies with asset more than \$50 billion.<sup>48</sup>

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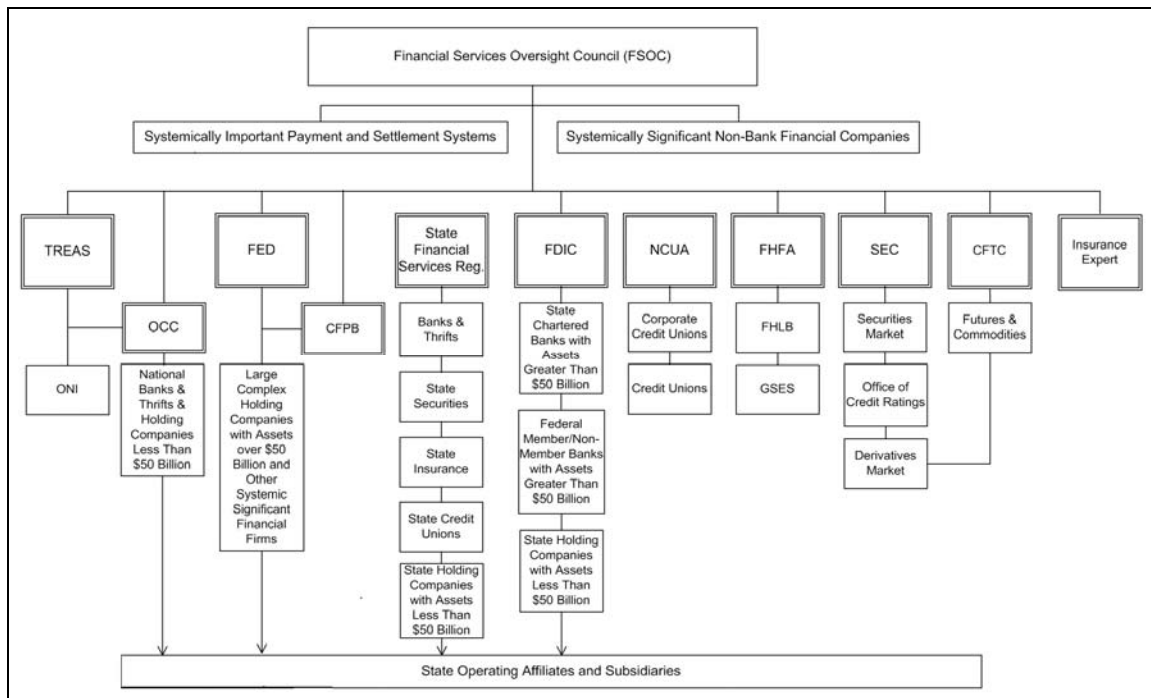
<sup>47</sup> Chairman Chris Dodd, Senate Committee on Banking, Housing, and Urban Affairs, *Summary: Restoring American Financial Stability—Discussion Draft*, Contact Kirstin Brost/Justine Sessions, March 17, 2010, 11 p.

<sup>48</sup> Ben S Bernanke, *The Federal Reserve’s role in bank supervision*, Testimony Before the Committee on Financial Services, U.S. House of Representative, March 17, 2010. p. 1.

## The Financial Stability Oversight Council (FSOC)

The FSOC would be the equivalent to the Financial Services Oversight Council in H.R. 4173. RAFFSA would create a systemic risk regulator headed by the Secretary of the Treasury. It would also create a board consisting of the heads of the major federal financial services regulators—the Office of the Comptroller of the Currency, the Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, the Federal Housing Finance Administration, the Securities and Exchange Commission, the Commodity Futures Trade Commission—and independent member with insurance expertise named by the President and confirmed by the Senate. It would create an office of national insurance in the Treasury and an office to regulate Nationally Recognized Statistical Ratings Organizations (NSRO) under the Securities and Exchange Commission. The FSOC would write rules concerning capital, leverage, risk management, and other requirements concerning financial companies’ growth, size, and complexity. The agency has the authority to impose penalties on companies that pose risk to the financial system. The FSOC would also have the authority to break up large, complex companies that pose a threat to the financial stability of the United States. The FSOC would oversee and identify important clearing, payments, and settlements systems that would be regulated by the Federal Reserve. The largest payment utilities, such as automated clearinghouses,<sup>49</sup> are owned by the Federal Reserve, but there are also very large privately owned as well as foreign-owned clearinghouses operating in the United States. The FSOC would create a new Office of Financial Research within the Treasury to support the council’s work by collecting and analyzing financial data to identify risk to the economy.

**Figure 6. Restoring American Financial Stability Act of 2010**



**Source:** Congressional Research Service.

<sup>49</sup> These clearinghouses are mainly paper checks and electronic clearing houses of payment transactions and not the clearinghouses that are being established for clearing derivatives and being discussed in the derivatives part of this legislation.

## **The Consumer Financial Protection Bureau (CFPB)**

The CFPB would consolidate all consumer protection responsibilities currently held by the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the Federal Reserve, and the National Credit Union Administration, except with regards to their primary examination and enforcement authority over banks, thrifts, and credit unions holding assets less than \$10 billion. The CFPB would be headed by an independent director appointed by the President and confirmed by the Senate. Like the Comptroller of the Currency, a bureau in the Treasury Department, the CFPB would be a bureau in the Federal Reserve Board. The purpose of the CFPB is to serve as a quick and responsive watchdog with the authority to write rules, supervise institutions, and enforce consumer protection laws. The bureau would have examination and enforcement powers for banks and credit unions with assets of over \$10 billion and all mortgage-related businesses (lenders, servicers, and mortgage brokers, and foreclosure scam operators). Within the CFPB there would be an Office of Financial Literacy. The agency would also regulate the shadow banking industry such as mortgage brokers and payday lenders. It would also allow states to pass tougher consumer protection laws by preventing federal regulation from preempting stricter state laws under certain circumstances.

The substantive authority of the CFPB would be almost identical to that of the CFPA in H.R. 4173. However, the CFPB would be placed within the Federal Reserve, generating some controversy.<sup>50</sup> There is some opposition in Congress to the CFPB, if it resides within the Federal Reserve System.<sup>51</sup> Some believe that separating consumer protection from safety and soundness regulation in different agencies would weaken safety and soundness enforcement, because consumer protection often means lowering the prices to the consumer; but if the institutions can not cover their cost at those prices, the institutions could have problems meeting safety and soundness requirements. Others believe that placing the consumer financial protection agency within the Fed will reduce the effectiveness of the agency, given that the Fed has a reputation amongst some for neglecting consumer protection.<sup>52</sup>

## **Redistributing Depository Institutions Among Regulators**

The RAFSA proposal would regulate federal regulated depository institutions excluding credit unions by distributing these institutions between the three remaining federal banking regulators—the FDIC, the OCC, and the Federal Reserve. The institutions that were regulated by the Office of Thrift Supervision would be merged into the FDIC and the OCC. The FDIC would regulate state banks and thrifts of all sizes and bank holding companies of state banks with assets below \$50 billion. The OCC would regulate all national banks and federal thrifts of all sizes and holding companies of state banks with assets below \$50 billion. There would be no new federal thrift

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<sup>50</sup> Mike Ferullo, “Dodd, Croker Seek Support for Plan to Create Strong Consumer Watchdog at Fed,” *BNA Banking Daily*, March 3, 2010, p. 2, [http://news.bna.com/bdln/BDLNWB/split\\_display.adp?fedfid=16362617&vname=bdbulallissues&wsn=500342000&searchid=10989940&doctypeid=1&type=date&mode=doc&split=0&scm=BDLNWB&pg=0](http://news.bna.com/bdln/BDLNWB/split_display.adp?fedfid=16362617&vname=bdbulallissues&wsn=500342000&searchid=10989940&doctypeid=1&type=date&mode=doc&split=0&scm=BDLNWB&pg=0).

<sup>51</sup> *Ibid.*, p. 3.

<sup>52</sup> R. Christian Bruce, “Regulatory Reform Creeps Ahead As Dodd, Shelby Trade Proposals,” *BNA Banking Daily*, March 2, 2010, p. 2, [http://news.bna.com/bdln/BDLNWB/split\\_display.adp?fedfid=16359529&vname=bdbulallissues&wsn=500366000&searchid=10989940&doctypeid=1&type=date&mode=doc&split=0&scm=BDLNWB&pg=0](http://news.bna.com/bdln/BDLNWB/split_display.adp?fedfid=16359529&vname=bdbulallissues&wsn=500366000&searchid=10989940&doctypeid=1&type=date&mode=doc&split=0&scm=BDLNWB&pg=0).

charters. The Federal Reserve would regulate all systemically important nonbank financial firms and holding companies with assets over \$50 billion. The Federal Reserve would lose supervisory authority over state-member banks but would be responsible for finding risk throughout the entire payment system with the vice chair of the Federal Reserve having the responsibility for supervision reporting to Congress semi-annually.

### **Office of National Insurance (ONI)**

RAFSA would create the ONI in the Department of the Treasury with the Secretary of the Treasury appointing the Director of the ONI who would be an advisor to the Financial Services Oversight Council. The duties of the ONI are to monitor the insurance industry and identify gaps; recommend to the Council any insurers that should be treated as systemically important; assist in administering the Terrorism Insurance Program; represent the U.S. in overseas forums such as the International Association of Insurance Supervisors; and determine whether state insurance measures are preempted by international agreements. The ONI must report to Congress on modernization and improving U.S. insurance regulation and the role of the global reinsurance market in support of insurance in the United States.

Unlike the H.R. 4173, RAFSA would give the ONI the power to issue subpoenas. RAFSA would also require the Director of ONI to submit a report to Congress, within 18 months of the establishment of the Office, on improving U.S. insurance regulation, which must cover the costs and benefits of potential federal regulation of insurance; feasibility of regulating only certain lines of insurance at the federal level; ability of federal regulation to minimize regulatory arbitrage; ability of federal regulation to provide robust consumer protection; and potential consequences of subjecting insurance companies to a federal resolution authority. RAFSA would also encourage state-based insurance reform with the National Association of Insurance Commissioners (NAIC) playing a critical role.

## **Structural Changes Through Reassigning Regulatory Responsibilities**

Of the three proposals, the Paulson proposal would have had the greatest consolidation of federal financial services regulators. It would have reduced the number of federal regulators from eight to three. The plan would have eliminated all bank charters except the national bank charter and would have preempted state regulation of the insurance industry and moved insurance regulation to the federal level. With such dramatic changes from the existing regulatory structure, the Paulson plan did not spell out how the enforcement mechanism would work in the newly created structure.<sup>53</sup>

The congressional proposals, H.R. 4173 and RAFSA, offer almost no federal financial services regulatory consolidation. Both congressional proposals would eliminate the Office of Thrift Supervision, which supervises less than 800 smaller depository institutions out of more than 8,000 such institutions in addition to the thousands of other financial services providers in the United States. The focus of the congressional proposals is more on regulatory responsibilities in

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<sup>53</sup> The Department of the Treasury, *Blueprint for a Modern Financial Regulatory Structure*, March 2008, p. 143.



distinct functions, which has become more complex than the competitive regulatory frameworks that were established over the years. For example, responsibilities of the Financial Services Oversight Council in the congressional plans were taken mainly from the Federal Reserve and placed within this new agency headed by the Secretary of Treasury but populated with the heads of nine federal financial regulators. In H.R. 4173, state financial services regulators are nonvoting members. On the other hand, the responsibilities of the Consumer Financial Protection Bureau or agencies in both congressional proposals were taken away from the existing federal financial services regulators and consolidated into this new regulatory body. **Figure 5** and **Figure 6** show that both the House and the Senate proposals would add new agencies by carving out regulatory responsibilities and assigning them to newly created agencies or redistributing federal regulatory responsibilities to existing agencies. The congressional financial regulatory proposals consolidate and enhance federal regulatory responsibilities and allocate them to different federal regulatory bodies, new and old.

## **Possible Implications**

The United States' functional and competitive regulatory structure has been effective primarily because of its ability to address deficiencies in financial institutions' management of risk. While doing this, the structure promotes economic growth by encouraging innovation, competition, and risk taking in the financial services markets. In addition, this structure is able to maintain its flexibility and resiliency. The 2007-2009 financial crisis is considered by many analysts as the greatest risk management failure in history and attributed to the federal regulatory structure, which is replete with costly redundancies that proponents call checks and balances, while opponents call needless duplications that get in the way of regulatory enforcement.<sup>54</sup> Regulators in this structure write rules, conduct on- and off-site monitoring, and examine financial services firms for compliance with their rules and regulations. Proponents also argue that the costs of these duplicated activities are affordable due to the benefits the stable financial services industry contributes to overall economic growth.

In addressing what some believe to be the greatest financial regulatory failure ever, the structural changes that Congress is proposing to make move in the opposite direction from consolidation of the financial services regulatory structure. In the legislation being considered, Congress has proposed to expand the regulatory structure to create more transparency and accountability. The proposals are consistent with the industry's and its regulators' arguments against creating a monolithic regulator, because it could lead to unchecked extension of regulation beyond the established jurisdictional boundaries. Congress is addressing the regulatory management failures, such as lack of accountability and transparency, that brought about the 2007-2009 financial crisis with the creation of a Financial Stability Oversight Council, which would regulate large financial and nonfinancial companies that threaten U.S. financial and economic stability, and oversee the payment system. Some argue that the crisis came about because the regulatory system did not protect consumers, even though all the federal financial regulators had the regulatory enforcement power to protect consumers. The congressional response to consolidate these regulations to protect consumers in a single agency is an attempt to address the identified deficiencies. This approach could prove to be a more effective way to improve the regulatory structure instead of consolidating all financial services regulatory agencies into one.

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<sup>54</sup> GAO-09-216, *A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory Structure*, January 2009, pp. 17-26

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