Streamlining the Regulatory Apparatus

By Kermit L. Schoenholtz


The Great Financial Crisis of 2007-2009, the most severe since the Great Depression, provides stark evidence of a colossal failure of U.S. financial regulation and supervision. In the United States, one of the reasons for that failure is the “complex, incoherent and fragmented regulatory system.” This byzantine apparatus made it virtually impossible for an observer—either a market participant, a financial executive, or a regulator—to view the financial system as a whole and to detect its vulnerabilities.

The U.S. regulatory system has been characterized as a “Rube Goldberg regulatory framework that is (fortunately) unique to the United States” (Cecchetti and Schoenholtz, “*The Scandal is What’s Legal*,” Money and Banking Blog, February 8, 2016). At the federal level, we have three bank regulators (the Federal Deposit Insurance Corporation, the Federal Reserve, and the Office of the Comptroller of the Currency) and two financial market regulators (the Commodity Futures Trading Commission and the Securities and Exchange Commission), as well as specialized regulators for a range of institutions and activities (including the National Credit Union Administration and the Federal Housing Finance Agency). We also have a college of regulators, the Financial System Oversight Council.
(FSOC), along with a Federal Insurance Office (FIO) that monitors that sector, and the Consumer Financial Protection Bureau (CFPB).

But this is only the tip of the regulatory iceberg. Each state has its own banking regulator. The states also have sole authority for the regulation and supervision of insurance and have their own state guarantee funds to backstop insurance contracts. State attorneys general also occasionally use state laws to impose structural changes in the financial industry (as in New York’s numerous conflict-of-interest suits against securities firms). Finally, on top of the federal and state regulators, there also are the officially authorized self-regulatory organizations, such as the Financial Industry Regulatory Authority and the Municipal Securities Rulemaking Board, along with the numerous finance and real estate industry associations that intensively lobby regulators and legislators alike.

This mix of complexity, loopholes and inefficiency is not news. An October 2004 Government Accountability Office report, appropriately titled “Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure,” highlighted the challenge both from the perspective of regulators and of the managers of a large, complex intermediary. Taken from that report, the following figure depicts the regulators of the various operations of a hypothetical financial holding company. With each regulator obtaining only a narrow stream of information about its slice of the holding company, no one is properly placed to assess the risks posed by the entire company to the financial system. At the same time, the company executives are unlikely to know precisely who is responsible for regulating each aspect of their enterprise, and may be especially uncertain in a crisis about how its multiple regulators will work (in concert or in opposition) to address the firm’s issues. And, this still leaves out the extraordinary challenges facing internationally active intermediaries that also face numerous foreign regulators.
Regulators for a Hypothetical Financial Holding Company

Note: Horizontal hash marks are author’s changes highlighting the impact of Dodd-Frank, which eliminated the Treasury Office of Thrift Supervision (OTS), placed thrifts under other regulators, introduced SIFIs, and placed S&L holding companies under the jurisdiction of the Federal Reserve. Source: Government Accountability Office, GAO-05-61, Figure 9, October 2004.

The 2007-2009 crisis revealed key weaknesses of the U.S. regulatory framework. Financial firms had evolved over time in ways that narrowed the differences between their economic functions (say, insurers versus banks), but their regulation remained segmented by their legal form, much as it had been since the 1930s. Above all, despite the vast expansion of de facto banking (as opposed to de jure banking) over the decades before the crisis, there was little prudential oversight over de facto bank activities, and virtually no awareness of the systemic vulnerabilities they created.
Yet, despite the biggest financial crisis since the 1930s, the Dodd-Frank Act did almost nothing to simplify the U.S. regulatory structure. Dodd-Frank eliminated just one federal regulator—the Office of Thrift Supervision (OTS)—which was arguably the most ineffective of the lot. The OTS had supervised AIG (because of a Delaware thrift that it owned), Countrywide, IndyMac, and Washington Mutual, all of which failed (or probably would have failed without federal support) in the 2007-2009 episode. Dodd-Frank added further to the mix by creating the CFPB, the FIO, FSOC, and FSOC’s information-gathering and assessment arm, the Office of Financial Research (OFR).

To the extent that there is any coordination at all, it is through the FSOC. But the FSOC’s authority over the various federal regulators is quite limited (consider, for example, the Securities and Exchange Commission’s resistance to reform of money-market mutual funds, the most bank-like of de facto banks). And, the FSOC has no direct influence over the state regulators or attorneys general.

Like Dodd-Frank, the Financial CHOICE Act also fails utterly to simplify this regulatory framework. The only organization that it would fully eliminate is the relatively tiny OFR that focuses on data collection and analysis and has no direct supervisory role. The CHOICE Act’s assertion that the OFR is redundant is wrong: While research divisions exist in each federal regulatory organization, they focus primarily on the risks arising either from their direct regulatees or the markets that they supervise. In contrast, the OFR is legally mandated to view the financial system as a whole in order to identify vulnerabilities that the FSOC should consider as potential systemic threats. Indeed, as the 2015 report of The Volcker Alliance has argued, “an appropriately empowered OFR could play the very important role of serving as a check on the agencies involved in
Could U.S. regulatory arrangements be radically streamlined, making the system more effective and less wasteful? Undoubtedly. The challenge of doing so is not conceptual, but political. Regardless of which party has majority control, Congress has shown no inclination over time to simplify the system. A Volcker Alliance background report (Elizabeth F. Brown, “Prior Proposals to Consolidate Federal Financial Regulators”) details more than a dozen proposals since 1960 for consolidating the U.S. regulatory system. The 2007-2009 financial crisis undermined many of the oft-repeated arguments against consolidation (such as reduced benefits of regulatory competition), leaving mainly the political turf considerations that animate the reluctance of the regulatory agencies themselves and, possibly, the Congressional committees that oversee them.

One recent and useful example of a proposed reform that did not receive serious Congressional consideration is the Treasury Department’s Blueprint for a Modernized Financial Regulatory Structure, published in March 2008 under Secretary Henry Paulson. The Blueprint thoughtfully acknowledged the “convergence of the financial services industry” in which intermediaries of different legal forms had evolved to provide services with similar economic functions. Its “optimal regulatory structure” shifted away from “institutionally based” regulation—which it viewed as broadly consistent with a segmented financial structure—to “activities-based” regulation. The key advantage of the latter “approach is that the same set of rules would apply to all institutions performing a particular activity.” It foresaw five agencies: a market stability regulator, a prudential financial regulator, a business conduct regulator, a corporate finance regulator, and a Federal Insurance

---

206 For the purpose of full disclosure, the author serves on the Financial Research Advisory Committee to the OFR.
Guarantee Corporation. Importantly, the prudential regulator would have oversight over any intermediary with a government guarantee (including either a continued state-level, or alternative federal, guarantee for insurers).

The CHOICE Act takes none of the steps—even those far short of the Blueprint’s optimal structure—that have been widely viewed as desirable simplification. For example, numerous proposals have called for combining the SEC and CFTC into one capital markets regulator. Similarly, one can easily imagine the creation of a single banking regulator (to replace the FDIC, Federal Reserve and OCC, as well as the state regulators) or a single insurance regulator and a federal guarantee fund (to replace the state-level operations that have become antiquated in a global financial system).

By contrast to the United States, most advanced economies have regulatory systems that are quite simple (see, for example, Elizabeth F. Brown, “Consolidated Financial Regulation: Six National Case Studies and the European Union Experience,” the Volcker Alliance). As the economy with one of the world’s most competitive financial centers, and one of the world’s largest banking sectors relative to its national income, the United Kingdom provides an important and useful regulatory benchmark for the United States. The U.K. regulatory system is composed of only three institutions: the Financial Policy Committee (FPC), the Prudential Regulatory Authority (PRA), and the Financial Conduct Authority (FCA). The FPC and the PRA are housed within the Bank of England (BoE). The FPC is responsible for macroprudential policy, while the PRA implements microprudential oversight over depositories, insurers and major investment firms. The FCA, organized outside of the Bank, sets conduct rules for more than 50,000 financial services firms and acts as the prudential regulator for firms not supervised by the PRA. Importantly, as the diagram below highlights, the BoE’s Governor and Deputy Governor for Financial Stability serve on the PRA Board and the FPC (as well as the Monetary Policy Committee),
encouraging the timely dissemination among policymakers of critical information about institutional and systemic vulnerabilities.

Membership of Bank of England Policy Committees


Surely, if U.S. policymakers wished to make the regulatory framework both effective and efficient, the United States is capable of organizing a system just as streamlined as that of the United Kingdom. The failure to do so reduces the nation’s attractiveness as a venue for global financial activity and makes it vulnerable to
future crises. This problem seems reminiscent of the period prior to the 1913 creation of the Federal Reserve, when the advanced nations of Europe viewed the U.S. banking system as dangerously fragmented and backward, and lacking a mechanism (a central bank acting as lender of last resort) to prevent and mitigate all-too-frequent panics.

The CHOICE Act simply does not address this problem of a byzantine regulatory framework.