

**Reform and Modernization of Financial Supervision in the United States:  
A Competitive and Prudential Imperative**

By

John R. Dearie and George J. Vojta

May 9, 2007

George J. Vojta is Chairman of the Advisory Board of the Wharton Financial Institutions Center.

John R. Dearie is a member of the Advisory Board of the Wharton Financial Institutions Center and Senior Vice President of the Financial Services Forum.

The views expressed in this paper are those of Mr. Vojta and Mr. Dearie. The ideas and arguments discussed within the paper should not be interpreted as necessarily representing the views of the Wharton Financial Institutions Center or the Financial Services Forum or its member institutions.

## Introduction

Capital is the lifeblood of any economy's strength and well-being, enabling the research and risk-taking that fuels competition, innovation, productivity, and prosperity. As the financial sector becomes more developed and sophisticated, capital formation and allocation becomes more effective and efficient, increasing the availability of investment capital and lowering costs. A deeper and more flexible financial sector also enhances the broader economy's resilience – its ability to weather, absorb, and move beyond the inevitable booms and busts of a dynamic economy. For these reasons, an effective and efficient financial sector is both a prerequisite and a “force multiplier” for progress and development – enabling, amplifying, and extending the underlying strengths of an economy.

The U.S. capital markets are the deepest, most sophisticated and efficient in the world, and an enormous strategic asset for the U.S. economy. Similarly, U.S. financial institutions are among the world's most competitive and innovative. And yet the apparatus of financial supervision in the United States remains a Depression-era patchwork of legal entity- and product-focused regulatory fiefdoms with overlapping jurisdictions, varying statutory responsibilities and powers and, too often, inconsistent supervisory postures, priorities, and methodologies.<sup>1</sup> These circumstances have increasingly led to needless duplication, regulatory arbitrage, structural imbalances, inefficiency and waste – with profound implications for the competitive position of U.S. financial institutions, the ability of supervisors to ensure safety and soundness and, therefore, systemic stability.

Opening a March 2003 FDIC symposium on the future of financial regulation, former FDIC Chairman Donald Powell stated:

“We've seen amazing dynamism and innovation in the marketplace over the last 20 years. Yet, the regulatory community is still mired in a confusing web of competing jurisdictions, overlapping responsibilities, and cumbersome procedures...Coordination difficulties, gaps in the seams among multiple regulators, confusion for the regulated firms, excessive costs, turf competition, and delays in our policy response to new developments all have potential to undermine our attempts to maintain financial stability.”

Speaking at the same conference, then chairman of the House Financial Services Committee, Michael G. Oxley (R-OH) added:

“The clear inefficiencies in the current system and the increasingly competitive nature of the international market are going to eventually collide and put U.S. financial services firms at a potentially serious disadvantage.”

---

<sup>1</sup> Four Federal banking agencies (the Federal Reserve, OCC, OTS, and FDIC), fifty state banking departments, one Federal securities regulator (the SEC) that outsources much of its oversight responsibility to two self-regulatory organizations (the NYSE and NASD) with inconsistent rules and requirements, and fifty state insurance departments.

On January 22, 2007, New York City Mayor Michael Bloomberg and Senator Charles Schumer (D-NY) issued a McKinsey & Company report detailing evidence that New York's status as the world's premier financial center is in jeopardy and offering a number of recommendations to strengthen the competitive position of the U.S. capital markets. On page 2 of their cover letter they write:

“The findings are clear: First, our regulatory framework is a thicket of complicated rules, rather than a streamlined set of commonly understood principles, as is the case in the United Kingdom and elsewhere.”

Two weeks later, on February 4<sup>th</sup>, Mayor Bloomberg traveled to London where he met with Sir Callum McCarthy, chairman of the UK's Financial Services Authority. Following the meeting, Bloomberg issued a statement reading: “The FSA is an example of the kind of streamlined and responsive regulatory framework Congress must implement if New York City is to remain the financial capital of the world.”<sup>2</sup>

On March 12, 2007, a bipartisan commission established by the U.S. Chamber of Commerce issued a report on the competitive position of the U.S. capital markets that concluded:

“Over the last two decades, markets have truly become global – corporations, accounting firms, investment banking firms, law firms, and now stock exchanges – all have internationalized. Yet, the U.S. regulatory structure is deeply rooted in reforms put in place in the 1930s, a period that was closer in time to the Civil War than it is to today.”<sup>3</sup>

In addition to undermining the competitiveness of U.S. capital markets, the complexity and inconsistencies of the U.S. framework of financial supervision also represent a major obstacle to greater international cooperation among financial supervisors. This reality is particularly troubling given the accelerating integration of global capital markets and the growing number of very large, highly complex financial institutions with activities in dozens of countries around the world.

To retain its global leadership position, the United States needs a 21<sup>st</sup> century supervisory system that is flexible, efficient, and responsive to the activities, innovations, and risks of the world's most sophisticated and dynamic capital marketplace. With the hope of stimulating discussion among financial authorities and policymakers, this paper briefly summarizes the rationale supporting financial supervision reform in the United States, some of the institutional and political obstacles to successful reform, and various reform options. It will also offer for consideration a particular reform option – the “GLBA-Plus” model (in reference to the Gramm-Leach-Bliley Act of 1999) – that, given the objectives of reform and the identified obstacles, would likely accomplish the most rationalization while raising few substantive or political objections.

---

<sup>2</sup> “Mayor Takes His Message to London,” The New York Times, February 5, 2007.

<sup>3</sup> See “Commission on the Regulation of U.S. Capital Markets in the 21<sup>st</sup> Century: Report and Recommendations,” U.S. Chamber of Commerce, March 2007, p. 2.

## Many Reasons for Reform

Rationalization of the nation's supervisory apparatus would yield a number of practical benefits for regulated financial institutions:

- Reduced Regulatory Burden and Costs: Regulatory compliance costs the financial services industry tens of billions of dollars each year, and further industry consolidation in recent years has only exacerbated the burden.<sup>4</sup> Financial holding companies might well be subject to supervision by six or more regulatory agencies – agencies that historically have tended not to cooperate or share information, contributing to needless redundancy and duplication.

As Bank of America CEO Ken Lewis pointed out in a 2004 speech: “Our company has at least 90 examinations scheduled for this year with five different Federal regulators – and that doesn't include the activities of the FDIC, which also has a resident examiner assigned to our headquarters in Charlotte. What more we have left to be inspected I don't know, but there's no question there are opportunities for streamlining.”

The complexity and duplication of the current supervisory framework also entails enormous costs to U.S. taxpayers. The combined budgets of the four Federal banking agencies (FDIC, OTS, OCC, and Federal Reserve) and the SEC – not including state banking, securities, and insurance agencies – topped \$5.5 billion in 2006. Howell Jackson of Harvard Law School has estimated that gross financial regulatory costs to U.S. taxpayers – even after adjusting for differences in GDP – are more than six times greater than in the United Kingdom.<sup>5</sup>

- An Improved Rule-Making Process: Recent years have witnessed a number of unfortunate examples of a poorly coordinated, often inconsistent regulatory rule-making process: the Fed's interim rule regarding capital requirements for merchant banking activities, the SEC's much-criticized rule regarding the “push-out” of banks' securities activities into affiliated securities subsidiaries, and the much criticized proposed implementation of the Basle II capital guidelines are but three examples. Inconsistency among supervisory agencies makes for bad policy and increases confusion, hassle, and costs for supervised institutions. A streamlined, more straightforward, and transparent rule-making process – one that entails cooperation among the relevant regulators and input from the industry – would promote more appropriate regulations and reduce costs and burden.

---

<sup>4</sup> The Securities Industry Association reports that compliance costs for the securities industry alone were \$25 billion in 2005. See SIA Research Reports, 7, February 22, 2006.

<sup>5</sup> Paper presented at symposium sponsored by Brooklyn Law School in 2002.

- Structural Distortions Minimized: A Byzantine framework of entrenched regulatory interests can lead to significant structural distortions. For example, of the more than 700 financial holding companies formed since passage of the Gramm-Leach-Bliley Act of 1999 (GLBA), less than 10 percent have been non-bank driven (securities or insurance firms moving into banking) – apparently due to non-bank reluctance to submit to supervision by the Federal Reserve. Such artificial, regulation-driven distortions undermine efficiency and innovation, entail significant costs, and generally impede the free and natural evolution of the financial system to the detriment of both users and providers of financial services. A simpler, more efficient supervisory apparatus would minimize or even eliminate such distortions, and promote a more appropriately structured, rational, and competitive system of capital formation and allocation.

Rationalization of the supervisory framework would also be consistent with several broad industry, legal, and international trends:

- Continuing Financial Convergence: Over the last twenty-five years, dramatic advances in computing and telecommunication technologies – and the heightened competition such advances give rise to – have driven a remarkable period of innovation that has blurred previously distinct sectors of the financial marketplace. Banks, securities firms, and insurance companies now develop and market similar products and services and compete directly with one another.

For example, money market mutual funds, CMA accounts, and other short-term instruments such as commercial paper enable securities firms to compete with banks for household and business funds, and to use these funds to compete in the short-term commercial and consumer credit markets. Variable annuities allow insurance companies to compete with securities firms for personal savings management, and guaranteed investment contracts permit them to compete with banks' interest bearing deposits and money market mutual funds. Stand-by letters of credit enable banks to offer insurance-like services, and securities firms accomplish something similar with special purpose vehicles that assume designated risks. More recently, credit derivatives, including synthetic securitizations, have further blurred the lines between formerly distinct products.<sup>6</sup>

As the assets and liabilities of financial institutions are increasingly disaggregated into their component risks, such product convergence will continue and institutional distinctions will likely become even less meaningful.

---

<sup>6</sup> A 1991 Treasury report entitled “Modernizing the Financial System,” noted that reform efforts focused solely on the banking system were “no longer appropriate, as depository and non-depository institutions have come to engage in similar activities and compete in the same markets.” Also see “Financial Services Consolidate, But Regulation is Still Fragmented,” *The New York Times*, Jan. 2, 1998; and “Bank Mergers Pose Challenge to Regulators,” *The New York Times*, April 17, 1998.

- Passage of the Gramm-Leach-Bliley Act: In November 1999, President Clinton signed into law the Gramm-Leach-Bliley Financial Modernization Act. The Act repeals the “Glass-Steagall” provisions of the Banking Act of 1933 and the Bank Holding Company Act of 1956 that restricted the ability of bank holding companies (“BHCs”) to affiliate with securities firms and insurance companies. GLBA authorizes BHCs that are well-managed and well-capitalized to become “financial holding companies” (“FHCs”) and to engage in a diversified range of financially related activities, including commercial banking, securities dealing and underwriting, insurance agency and underwriting activities, and merchant banking. It also permits other firms engaged in financial activities to acquire or charter banks and to become FHCs. Congress’ principal intent in passing GLBA was to enable financial services firms competing in an increasingly global and competitive marketplace to organize themselves in response to customer needs and shareholder priorities, rather than remaining bound by the arbitrary limitations of an outdated regulator framework.
- The International Trend Toward Regulatory Consolidation: In recent years, a number of countries with advanced capital markets have moved to consolidate supervisory authorities. This trend is driven by two principal forces: the continued convergence of financial products mentioned above, and the associated formation of financial conglomerates.

In Japan, the Financial Services Agency was established on July 1, 2000 by the merging of the Financial Supervisory Agency and the Ministry of Finance’s Financial System Planning Bureau.<sup>7</sup> The FSA has broad regulatory authority over banking, securities, and insurance, and has integrated responsibility for financial system planning, the inspection and supervision of financial institutions, and the surveillance of securities transactions.<sup>8</sup>

The United Kingdom’s own combined FSA, the Financial Services Authority, was launched in the fall of 2001. The super-agency, the result of financial reforms initiated soon after Tony Blair was elected prime minister in 1997, combined nine formerly separate regulators and also assumed the Department of Trade and Industry’s responsibilities for investigating insider trading. The FSA, which now oversees some 10,000 companies, combines regulatory duties that in the United States are divided among the SEC, the Federal Reserve, the CFTC, the OCC, the OTC, the FDIC, and 50 state bank, securities, and insurance regulators.<sup>9</sup>

---

<sup>7</sup> See “Japanese Regulators Start Regulating – Fledgling FSA Gets Respect of Financial Community in Wake of Cresvale Case,” *The Wall Street Journal*, Sept. 17, 1999.

<sup>8</sup> See “On the Establishment of the Financial Services Agency,” Masaharu Hino, Commissioner of the FSA, at the Bank of England, September 2000.

<sup>9</sup> See “Britain’s Fiscal Watchdog to Bite as Well as Bark,” *The Wall Street Journal*, November 30, 2001.

Regulatory consolidation is also underway elsewhere in Europe. On January 25, 2001, German Finance Minister Hans Eichel announced plans to form the “Allfinanz” supervisor, which would combine the oversight of banking, securities, and insurance. Later that year, Greece and Ireland announced their own financial reforms plans, pledging to closely study the single regulator option.<sup>10</sup> Other European nations that have moved toward regulatory consolidation include Belgium, Denmark, Finland, Norway, Switzerland and Sweden. Consolidation has also been initiated in South Korea, Australia, Iceland, Mexico, and Canada.

In addition to the regulatory consolidation occurring *within* individual European countries, the EU has taken steps to enhance regulatory harmonization *across* member states. Initial efforts have been to coordinate among the various member states in the supervision of individual sectors. To accomplish such cooperation, the EU has created advisory and consultative committees – one for each financial industry sector – whose task is to identify differences in national standards that impair the development of an integrated European financial market. The committees make recommendations to the European Commission and the Parliament, which has the authority to impose EU-wide legislation that would preempt existing national statutes.

- Europe’s Financial Conglomerates Directive: As part of the EU’s integration effort, on April 26, 2001 the European Commission (EC) adopted a proposal regarding the supplementary supervision of banks, securities firms, and insurance companies operating within a financial conglomerate. The proposed Directive – a priority measure under Europe’s Financial Services Action Plan – was prompted by continuing consolidation in the financial services sector, and recognition on the part of the Commission that: 1) conglomerates pose significant potential risks to the financial system and broader economy; and, 2) existing supervisory requirements inadequately address those risks.

The three major objectives of the Directive are:

- To ensure that conglomerates are adequately capitalized – in particular, to prevent capital from being counted more than once (“multiple gearing”), and to prevent “downstreaming” by corporate parents;
- To introduce methods for calculating overall solvency; and,
- To deal with the issues of intra-group transactions, combined risk exposure, and professional and managerial standards.

Perhaps most significantly – at least to U.S.-based institutions with operations in Europe – the Directive also requires that the holding companies of foreign firms with operations in Europe be “subject to supervision by a third country competent

---

<sup>10</sup>See “Single Financial Regulators Are Catching On in Europe,” *The Wall Street Journal*, March 6, 2001.

authority that is equivalent to the provisions of the Directive.” In other words, diversified financial institutions must be subject to consolidated supervision. While an acceptable understanding has apparently been reached between U.S. and European regulators, the Directive continues to represent a potential problem for U.S. securities firms and insurance companies, which are not supervised at the holding company level, nor are they regulated to the same extent as European securities firms at the operating level.

In addition to these broad industry and international trends, a number of specific regulatory issues have emerged in recent years that also illustrate the mounting logic for some kind of broader supervisory reform:

- No Federal Supervision of Insurance: The insurance industry, like other sectors of the U.S. financial services industry, has consolidated in recent years and an ever-larger number of insurance companies are active in many states – a reality that makes compliance with individual state standards increasingly cumbersome and costly. Although the National Association of Insurance Commissioners has taken steps to make state regulations more uniform, significant differences remain that require large insurance institutions to maintain separate legal and compliance units for each state in which they operate. The problem is particularly acute for life insurers given that federally regulated banks and securities firms offer closely competitive products.

A Federal insurance supervisor, charged with establishing and enforcing the full array of prudential requirements, would promote the harmonization of standards and the consistent application of best practices. A Federal supervisor and charter option would also bring to the regulation of insurance the widely recognized benefits of the dual banking system, including greater regulatory competition and vitality. Finally, a Federal insurance supervisor and charter option would address lingering concern regarding the EU’s Financial Conglomerates Directive, which, as mentioned above, requires that all diversified financial holding companies be subject to consolidated supervision.

- Inadequate Oversight of Housing-Related GSEs: Another highly desirable change to the current apparatus of financial supervision is to enhance the supervision of the housing-related government-sponsored enterprises (GSEs) – particularly Fannie Mae and Freddie Mac, but also including the Federal Home Loan Banks – to ensure their safety and soundness and to protect the broader financial system.

The GSEs effectively fulfill their Congressionally-mandated objective of providing liquidity in the secondary mortgage market. But given their enormous size, the rapid rate at which their balance sheets and outstanding debt have grown in recent years, their expanding activities, and the complex array of risks to which their earnings and capital are exposed, it is clear that the GSEs should be subject to rigorous and comprehensive supervision. Indeed, members of Congress, the Bush Administration, and a number of economists and financial policy analysts have expressed growing

concern that OFHEO does not have the resources, the organizational capabilities or independence necessary to adequately supervise institutions of Fannie and Freddie's size and complexity. A new agency – a bureau within the Treasury Department or free-standing like the SEC – independent of the appropriation process, adequately funded and staffed with personnel with extensive experience in mortgage markets, housing policy, risk management, accounting and control systems should be a top reform priority.

- Federal Preemption of State Authority: On January 7, 2004, the OCC issued new rules asserting preemption of state laws regarding the activities of nationally chartered banks and the state-chartered operating subsidiaries of nationally-chartered banks. The OCC has asserted that preemption is necessary to avoid a confusing and costly patchwork of regulatory requirements regarding such issues as consumer protection, is altogether consistent with the system of “dual banking” (i.e., state and Federal), and is backed up by 140 years of legal precedent. Consumer advocates have panned the OCC's action, claiming the OCC is far too lenient with large financial institutions.

As these few examples make clear, the landscape of financial supervision in the United States is becoming more confused and less efficient – even as the activities and related risks of U.S. financial institutions continue to grow in complexity. Such a mish-mash of variegated oversight does not inspire confidence in supervisors' ability to ensure safety and soundness, or that the supervisory treatment of institutions developing and marketing substantially similar products and services – and, therefore, exposed to substantially similar risks – will be sufficiently responsive, fair, or consistent.

Most fundamentally and importantly, the present system seems no way to supervise the world's most sophisticated and dynamic financial marketplace.

### **Structural Reform an Uphill Battle**

Despite the many benefits that supervisory modernization would yield – and the broad industry and international trends that seem to call for rationalization – any ambitious reform effort would face significant political obstacles.

The most basic and, perhaps, most important of these political realities is the American aversion to concentrated political and economic power. This sentiment is longstanding and deeply rooted, reaching back to the very beginnings of the Republic and remaining a singular sensibility of the American political psyche. Indeed, it is as much responsible for the highly decentralized and duplicative nature of the nation's current framework of financial supervision as it is for such sacrosanct political concepts as “the separation of powers” and “checks and balances.” Any meaningful approach to supervisory reform would need to reflect and be in keeping with this centrally important political reality.

A close corollary to the aversion to “bigness” is the purported benefits of professional competition among multiple regulators. Federal Reserve chairman Alan Greenspan spoke to this issue in 1994:

“A consolidated single regulator would deprive our regulatory structure of what the Board considers to be the current invaluable restraint on any one regulator conducting inflexible, excessively rigid policies. The dual banking system and multiple Federal regulators have facilitated diversity, inventiveness and flexibility in our banking system, so important to a market economy subject to rapid change. A single Federal regulator would effectively end the dual banking system.”

In this regard, it is worth noting that initial reviews of the United Kingdom’s FSA – a reasonable prototype for full-scale regulatory consolidation – were decidedly mixed. In May 2001, a survey of officials at 70 financial institutions, both British and foreign institutions with operations in the UK, revealed that many regarded the FSA as “bureaucratic, intrusive and insensitive,” which could eventually undermine the City’s international competitiveness.<sup>11</sup>

Another obstacle to genuine reform is simple human inertia – the mere resistance to change. Former comptroller of the Currency John D. Hawke, Jr. acknowledged this reality during a speech before the National Association of Business Economists on March 25, 2002. Mr. Hawke conceded that the current regulatory apparatus “presents an inviting target for rationalization and restructuring,” but added: “As someone who has spent the better part of a long career working within that structure, I confess to a certain affection for it, in all its convoluted glory...and the various players have learned how to live with it.”

The regulators aren’t the only ones who have grown accustomed to the current supervisory landscape – so have the regulated institutions themselves, who are not only used to the arrangement, but have learned over the years how to effectively game and arbitrage the system. A rationalized supervisory apparatus, however desirable from a public policy perspective, would mean new rules, new ways of doing things, and significant uncertainty – bringing to mind the old expression: “I’ll stick with the devil I know rather than take a chance on the devil I don’t know.”

## **Reform Options**

Despite these significant obstacles, meaningful supervisory reform is neither impossible nor undesirable. Indeed, it seems obvious that to retain its global leadership position, the U.S. financial system needs an efficient, flexible, and responsive system of supervision and regulation given: 1) the accelerating pace of technology-driven innovation; 2) the increasing size of financial conglomerates; 3) the increasingly complex mix of financial activities and the associated risks; 4) the wave of regulatory rationalization occurring elsewhere around the world; and, 5) the unprecedented and intensifying competition from foreign capital markets. But to be successful, any serious reform effort would have to take into account – and meaningfully address – the potent political realities discussed above.

---

<sup>11</sup>See “New UK Financial Regulator Draws Fire,” *The Wall Street Journal*, May 30, 2001.

With all this in mind, there seem to be five major reform alternatives:

Option #1: An FSA-like Single Supervisory Agency

The most straightforward and aggressive reform option would be to simply merge all existing supervisory agencies into one super-agency, like the UK's FSA. The principal advantage of this option is simplicity – the ability of a single supervisor to evaluate all U.S. financial institutions' activities and risks in a comprehensive and consistent manner. But this option would be so utterly inconsistent with the deeply-held American aversion to concentrated power, and would generate so much opposition from the financial industry and existing supervisory agencies, that it is best set aside as a non-starter.

Option #2: Consolidation of Bank Examination Authority

At present, the Federal Reserve supervises all bank holding companies (including FHCs), as well as state-chartered banks that are members of the Federal Reserve System. The OCC, a Treasury agency, charters and supervises national banks. The OTS, also a Treasury agency, charters and supervises Federal thrift institutions. The FDIC administers the deposit insurance fund for banks and thrifts and examines state-chartered banks that are not members of the Federal Reserve System. With all these agencies doing essentially the same thing, it would seem that consolidation would be both logical and relatively easy.

The most straightforward and politically feasible consolidation approach would be to fold the examination responsibilities of the four Federal banking agencies into the OCC: the OTS would cease to exist; the FDIC would continue to administer the deposit insurance fund, but would no longer examine banks; the Fed would retain its “umbrella” oversight of bank holding companies, but would no longer examine banks on site. This reform option has several advantages:

- Both the OCC and OTS are Treasury agencies and both charter and supervise depository institutions. There are few remaining meaningful differences between banks and thrifts. Merging the OCC and the OTS – which have similar cultures and regulatory methodologies – would leverage significant economies of scale and produce a more prestigious agency with a broader, more diverse funding base.
- Banks supervised by the Fed are chartered by, and supervised by, the state banking departments.
- The arrangement would preserve the dual banking system – an option of either Federal or state chartering and supervision – thereby retaining a degree of regulatory competition.

Of course, stripping the Fed and FDIC of examination powers would entail certain problems:

- Both agencies would argue that on-site examination of banks is essential to fulfilling their other responsibilities.<sup>12</sup> Such concerns could be at least partially addressed by requiring that examination reports and other relevant supervisory information be shared with the Fed and FDIC.
- Consolidation would also raise concerns that a single bank agency would reduce regulatory competition, thereby undermining innovation and contributing to regulatory hubris. This concern is substantially answered by the continued existence of 50 state-based alternatives.

### Option #3: Reduction of Four Bank Regulators to Two

An alternative to full consolidation of the banking agencies is partial consolidation whereby the OCC and Federal Reserve would share bank supervisory duties. This option was recommended by the Treasury in its 1991 modernization proposal (the Brady Report).

As in the reform option above, the OTS would be absorbed by the OCC and the FDIC would be stripped of its bank examination powers. Nationally-chartered banks, and the bank holding companies of nationally-chartered banks, would be supervised by the OCC. State-chartered banks, and the bank holding companies of state-chartered banks, would be supervised by the Fed. In the case that a BHC had both national and state-chartered banks, jurisdiction would go to the supervisory of the largest banking subsidiary.

The advantages of this arrangement include:

- The present confusion and duplication stemming from supervision of a nationally-chartered bank by the OCC and its bank holding company by the Fed would be eliminated;
- Two Federal authorities would preserve a greater degree of regulatory competition;
- Given that it would retain extensive examination powers, the Fed – a powerful force on Capitol Hill – would likely not strenuously object to the loss of its authority over some bank holding companies.

The principal disadvantage of this arrangement is that only modest consolidation would be accomplished.

---

<sup>12</sup>For a discussion of the Federal Reserve's argument regarding the importance of supervisory powers to its other duties as the central bank, see the testimony of Alan Greenspan, Chairman of the Federal Reserve Board, before the subcommittee on Capital Markets, Securities and GSEs of the House Committee on Banking and Financial Services, March 19, 1997.

#### Option #4: Creation of a Financial Services Commission

A new Financial Services Commission (FSC) could be established to oversee and coordinate the activities of the existing banking agencies and the SEC. If a Federal insurance authority were ever created by Congress, it too would be included with the other Federal agencies under the umbrella of the FSC. Members of the Commission would likely come from the coordinated agencies, but could also be independent or both.

Advantages of this arrangement include:

- More effective coordination between the supervisory agencies and a facilitated rule-making process would reduce regulatory inconsistencies and the resulting industry confusion. It would also help reduce regulatory duplication, thereby lowering the costs and burden of compliance.
- A multi-headed commission would be preferable to a single FSA-like supervisory authority in that it would reflect the coordinated functions and priorities of the existing agencies.
- Creation of an FSC would preserve existing agencies and would therefore avoid the objections that consolidation would evoke.

The disadvantages of creating an FSC include:

- A new Commission, or “College of Cardinals,” set up to referee the activities, policies, and disputes of the Federal agencies, while perhaps reasonable in theory, might be extremely cumbersome in practice. Indeed, the effect of creating an FSC might well be to institutionalize the lack of cooperation, sniping, and turf battles that occurs among the agencies now.
- More fundamentally, creation of an FSC would be inconsistent with the most basic objective of reform – to rationalize the current system. As noted above, the arrangement would preserve all existing agencies – and would create *yet another* party to financial supervision.

#### The GLBA-Plus Model

The options discussed above each have certain advantages, but none accomplishes truly meaningful rationalization and all have significant disadvantages. A final option, the “GLBA-Plus” model, would accomplish significant rationalization and, while bold, would likely raise comparatively few objections. The model would build on the two-tiered supervisory framework of “umbrella supervision” and “functional regulation” introduced by GLBA, and is something of a combination of option #2 (full consolidation of on-site bank examination powers) and the FSC option discussed immediately above.

The first step would be to consolidate the on-site examination responsibilities of the four existing Federal banking agencies – the Federal Reserve, OTS, FDIC, and OCC – within the

OCC, which would become the single Federal banking agency with on-site examination powers. The OTS would cease to exist. The FDIC would continue to administer the deposit insurance fund, but would no longer examine banks on site.

The Federal Reserve also would no longer conduct on-site examinations of banks, but would retain its “umbrella” oversight of bank holding companies and FHCs. Indeed, its oversight authority would be extended to include all banks, securities firms, and insurance companies. The Fed would not have the authority to examine banks, securities firms, or insurance companies on site. Instead, it would rely on the OCC, the 50 state banking departments, the SEC, the 50 state insurance authorities, and the Federal insurance authority (if ever created) for examination reports and other relevant information – in the same manner that it currently relies on the functional regulators under the GLBA regime.

The GLBA-Plus model would have all the advantages of consolidating the examination responsibilities of the four existing Federal banking supervisors *and* the creation of an FSC, plus:

- The Fed is already an umbrella supervisor. It has supervised bank holding companies since 1956 – a period during which a number of BHCs maintained non-bank entities overseas – and, following enactment of GLBA, has developed significant additional expertise supervising diversified financial conglomerates that include banking, securities, and insurance entities.
- As a true umbrella supervisor, the Fed’s role would be to assess in a comprehensive way the condition, activities, consolidated capital, risk management, internal controls, corporate governance, and overall safety and soundness of all U.S.-based financial institutions, thereby improving supervisory consistency and effectiveness.
- Umbrella oversight by the Fed would promote greater cooperation among the regulatory agencies and a more unified, coherent, and transparent rulemaking process – without creating an additional coordinating authority.
- By stripping the Fed of all on-site examination authority, the GLBA-Plus model would eliminate the vagueness of the “reason to believe” language in GLBA regarding the Fed’s present authority to by-pass a functional regulator and impose an on-site examination on a non-bank subsidiary of an FHC. This uncertainty – and the prospect of suddenly being subject to Fed examination – is a major reason why many non-banks have chosen not to diversify into banking.
- By making all financial institutions subject to consolidated supervision, the GLBA-Plus model would eliminate any residual uncertainty on the part of U.S. securities firms and insurance companies with regard to the EU’s Directive on financial conglomerates.
- By incorporating most existing regulatory agencies, the GLBA-Plus model would preserve regulatory specialization as well as the long acknowledged benefits of regulatory competition and innovation.

- And finally, while achieving significant rationalization of the present framework, the model, by preserving most existing agencies, would not raise objections to concentrated regulatory power that a single, monolithic supervisory authority is likely to evoke.

Like any reform option, the GLBA-Plus model entails certain complications:

- The Fed and FDIC would surely argue that on-site examination of banks is essential to fulfilling their other responsibilities. These concerns would be addressed by requiring that examination reports and any other relevant supervisory information be routinely forwarded to the Fed and FDIC. The Fed's concerns might also be significantly allayed by the extension of its umbrella oversight authority to include all financial institutions.
- The other regulatory agencies and some policymakers can be expected to object to the extension of the Fed's umbrella authority to include oversight of securities firms and insurance companies. But such objections can be answered by pointing out that the Fed would be stripped of its on-site examination authority, and that the GLBA-Plus model merely broadens the two-tiered system of supervision – umbrella supervision and functional regulation – already in operation.

For the GLBA-Plus model to be most effective, other changes would be desirable in addition to the rationalization summarized above. For example, allocating additional resources to the SEC would help broaden the supervisory posture of the agency. At present, the SEC's activities are limited to the enforcement of securities laws and customer protection. The agency does not evaluate the risk management procedures and methodologies of securities firms, or the effectiveness of internal controls. In other words, it does not assess "safety and soundness." In this sense, the SEC is a regulator, not a supervisor. If the Federal Reserve, as the umbrella supervisor, is to fully and confidently rely on the SEC's assessment of securities firms, the SEC's priorities, activities, and methodologies should be amended to be more in keeping with those of a true supervisor.

In addition, for the Federal Reserve to serve as a true umbrella supervisor and assess the safety and soundness of all financial institutions in a manner that is consistent and fair, a more unified approach to evaluating the capital adequacy, risk management, and control apparatus of banks, securities firms, and insurance companies should be developed. Efforts have been underway for years, both domestically and internationally (e.g., within the Basel Committee on Banking Supervision, IOSCO, and the Joint Forum) to develop evaluation standards that can be commonly applied to banks and securities firms. Incorporating insurance companies into a single evaluation approach is tricky, given the unique risks to which insurance activities are subject. Nevertheless, some approximation of common assessment must be accomplished if financial institutions are to be supervised in a manner that would not favor or impede particular classes of institutions – a situation that would only encourage the kinds of structural distortions and inefficiencies that reform and modernization should aim to eliminate.