Four Challenges to Financial Regulatory Reform

Eric J. Pan

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FOUR CHALLENGES TO FINANCIAL REGULATORY REFORM

ERIC J. PAN*

I. INTRODUCTION

THE recent global financial crisis represented a failure of regulation. This statement is not to say that regulators and particular regulations caused the financial crisis; the events of the crisis stemmed from an array of factors, including arguably short-sighted and reckless acts by both consumers and financial institutions. Rather, viewing the financial crisis as a failure of regulation means recognizing that there existed regulatory responses and strategies that could have prevented or mitigated the factors that contributed to the crisis.

Consider, for example, the five causes of the financial crisis identified by the U.S. President’s Working Group on Financial Markets: a breakdown in underwriting standards for subprime mortgages and questionable lending practices to less qualified homebuyers; erosion of market discipline by parties to the mortgage securitization process; flaws in credit rating agencies’ assessments of subprime mortgages; risk management weaknesses at large financial institutions; and failure by financial institutions to mitigate these risk management weaknesses. With respect to each one of these causes, however, it is possible to identify corresponding regulatory failures. The practice of selling subprime mortgages to homebuyers with poor credit or insufficient income, for example, reflected the absence of adequate consumer protection and business conduct regulation. Regulators could have helped address the risk management weaknesses at the large

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financial institutions if they exercised tougher prudential supervisory oversight.²

Likewise, the lack of supervision of non-bank financial institutions, such as investment bank holding companies, private equity funds, and hedge funds, constituted a problem of under-regulation—in the sense that no regulatory agency had complete responsibility for overseeing these institutions. At the same time, the regulation of multi-function financial supermarkets constituted a problem of overlapping regulation—in the sense that these institutions were subject to oversight by multiple agencies, none of whom coordinated their supervisory efforts with their counterparts. The failure of credit rating agencies to provide accurate and timely ratings reflected the problems and challenges of regulating market gatekeepers, and the danger of relying on industry self-regulation and market discipline to ensure appropriate conduct. Finally, the spread of the financial crisis from the United States to Europe and other regions of the world exposed weaknesses in efforts by national regulators to share information in a timely manner, cooperate in the supervision of international financial firms, and coordinate regulatory responses. The crisis also exposed national regulators' loss of confidence in the principle of home country supervision of international financial firms.

TABLE 1 - FINANCIAL CRISIS AS REGULATORY FAILURE

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<tr>
<th>Contributing Factors to Financial Crisis</th>
<th>Type of Regulatory Failure</th>
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<tr>
<td>Predatory lending</td>
<td>Lack of consumer protection regulation</td>
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<tr>
<td>Unsophisticated investors and borrowers</td>
<td>Lack of consumer protection regulation</td>
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<td>Risk management weaknesses</td>
<td>Failure of prudential supervision</td>
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<td>Failure of credit rating agencies and other market gatekeepers</td>
<td>Failure of self-regulation</td>
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<td>Unregulated financial entities and instruments</td>
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<td>Financial supermarkets</td>
<td>Overlapping and competing regulation and under-regulation</td>
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<tr>
<td>Cross-border financial contagion</td>
<td>Lack of international cooperation and doubts concerning home country supervision</td>
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<tr>
<td>Crisis response</td>
<td>Absence of market</td>
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</table>

Recognizing the failure of regulation in preventing the recent financial crisis and the need to pursue more effective regulatory strategies, policymakers in the United Kingdom, United States, and European Union—the jurisdictions with the largest and most sophisticated financial markets in the world—set forth concurrent proposals for substantial reform of their respective regulatory systems. The reforms emphasized the reorganization of regulatory agencies and expansion of the powers of surviving agencies. While the unique political and economic circumstances of each jurisdiction influenced the nature of the proposals, each aimed to address the same problems that the crisis exposed. Despite their common objectives, however, the proposals differed significantly from each other. These differences should cause concern as they indicate that the reform proposals—and any future proposals that fail to address such difference—will not be entirely successful in preventing future crises.

Successful financial regulatory reform must address four challenges. First, how should regulatory systems be structured? Each jurisdiction must consider how to divide responsibilities among regulatory agencies and whether consolidation of such responsibilities in a smaller number of agencies is desirable. Central to this challenge is determining how to ensure coordination between separate agencies and how to set regulatory priorities when there are differences between agencies.

Second, should there be a separation of prudential supervision and consumer protection regulation? Each jurisdiction must decide on the validity of the logic of the "twin peaks" model. Such logic states that there is an inherent conflict between prudential supervision and consumer protection regulation and that such regulatory pursuits must be kept separate. Proposals to create independent agencies focused exclusively on consumer protection appear to signal wider acceptance of the logic of twin peaks in the United States and United Kingdom, but not elsewhere in the European Union.

Third, which entity should be responsible for monitoring and managing systemic risk and what should be its powers? Systemic risk regulation requires both the active monitoring of events and market developments that may lead to market instability and the ability to impose corrective action on the markets to contain systemic risk events. Given the broad powers and responsibilities that must be vested in such a regulator, policymakers need to decide which agency is in the best position to assume this role or, if more than one agency will be given the task, whether multiple agencies can effectively share the responsibility and powers for systemic risk regulation.

Fourth, how should cross-border financial services and transactions be supervised and regulated? As aggressively as jurisdictions pursue financial regulatory reform at home, they remain vulnerable to the effects of future financial crises if there is inadequate regulation and supervision of financial institutions abroad. Unfortunately, cross-border regulation and super-
vision remain limited and ad hoc. Part of the problem with cross-border regulation and supervision is that the most common models of international regulatory coordination are not effective in addressing the types of cross-border problems underscored by the recent financial crisis. Specifically, the challenge for the global financial system is not only the setting of common rules and standards (i.e., the challenge of harmonization), but also the continuous sharing of information, collaboration on supervision, and implementation of technical standards (i.e., the challenge of cooperation). Furthermore, cross-border cooperation always will struggle with the problems of prioritization of domestic concerns above international ones and the legitimacy and accountability of international regimes. Many of these problems, however, may be overcome if there is a new focus on bilateral arrangements, especially between the United States and European Union, where there is greater commonality of interests and eventually the development of stronger international regimes.

This Article first outlines the main regulatory reform proposals set forth in the United Kingdom, United States, and European Union. While these proposals undoubtedly will change—or even be rejected—as a result of political debate and the legislative process, this Article considers only the original form of each proposal set forth in mid-2009. The proposals represent each jurisdiction’s clearest statement by its executive authority as of early 2010 regarding the optimal strategy for financial regulatory reform. The Article then considers the four challenges to regulatory reform and evaluates how each reform proposal addresses these challenges. The Article explains that the proposals fail to answer the challenges. Given their failure, the Article concludes that the reform proposals considered by the United Kingdom, United States, and European Union are not going far enough to prevent future regulatory failures.

II. Proposals for Regulatory Reform

In 2009, policymakers in the United Kingdom, United States, and European Union announced several proposals for the reform of their respective financial regulatory systems. The following is a brief description of each proposal.


4. See id. at 31-42.

A. United Kingdom

In the United Kingdom, three proposals put forward by the Financial Services Authority (FSA), HM Treasury, and the opposition Conservative Party dominated the national debate on financial regulatory reform. In its March 2009 report known as the “Turner Review,” the FSA recommended broadening the agency’s objectives and powers to allow it to play a bigger role in the monitoring of systemic risk threats. The Turner Review noted that the FSA failed to detect and prevent many of the activities that led to the financial crisis because it did not believe it had to so intensively supervise some of the large U.K. depository institutions or extend supervision over certain unregulated financial institutions. As a result, the majority of the report focused on improving the FSA’s supervision of large banks and non-bank financial institutions. Recommended improvements included devoting more supervisory resources to systemically important firms—or what some would call “too-big-to-fail” entities—hiring more skilled and better trained regulatory personnel, and paying greater attention to credit and liquidity risk. Specific report proposals included raising capital adequacy requirements for financial institutions and increasing the coverage of deposit insurance, developing and enforcing U.K. and international codes for executive compensation, creating a central counterparty for credit default swaps, and promulgating more stringent conflict of interest rules for credit rating agencies. In terms of regulating cross-border financial institutions, the Turner Review not only advocated the use of colleges of national supervisors, but also recommended that the FSA regulate more stringently U.K. subsidiaries of non-U.K. financial institutions even though such a move might subject international institutions to overlapping national regulation, hindering the provision of cross-border financial services. The Turner Review, however, did not recommend any changes to the tripartite arrangement that has divided the responsibility for U.K. financial market regulation between the FSA, the Bank of England, and HM Treasury. Rather, it recommended that together the FSA and Bank of England should be given explicit responsibility for ensuring market stability, arguing that the FSA should be an equal partner of the Bank of En-


7. The tripartite arrangement refers to a division of responsibilities governed by a memorandum of understanding between the Bank of England, the FSA, and HM Treasury. Per the arrangement, the FSA would supervise banks and other financial institutions, the Bank of England would serve as monetary authority and the lender of last resort, and HM Treasury would provide public funding to the markets. See HM Treasury, Memorandum of Understanding Between the Bank of England, the Financial Services Authority, and HM Treasury (last updated Mar. 22, 2006) [hereinafter Tripartite MOU], available at http://www.hm-treasury.gov.uk/documents/financial_services/regulating_financial_services/fin_rfs_mou.cfm.
gland in monitoring and responding to systemic threats to the financial system.

In July 2009, HM Treasury published its White Paper, "Reforming Financial Markets." The HM Treasury White Paper generally endorsed the recommendations of the Turner Review. The main question addressed by the White Paper was whether the Bank of England should assume greater prudential supervisory responsibility. If so, the Bank of England would assume some of the powers previously reserved to the FSA. In agreement with the FSA’s view expressed in the Turner Review, HM Treasury recommended no changes to the old arrangement of shared responsibility between the FSA and the Bank of England. Rather, it sought to improve coordination between the two agencies by establishing a formal Council of Financial Stability composed of HM Treasury, the FSA, and the Bank of England and chaired by the Chancellor of the Exchequer. The Council would replace the memorandum of understanding that governed the tripartite arrangement. The Council, however, would not have its own staff or any independent policymaking authority.

Even after the publication of the Turner Review and HM Treasury White Paper, which appeared to make similar recommendations, the future of the U.K. financial regulatory system remains uncertain. The Conservative Party issued its own report in July 2009 calling for an end to the tripartite arrangement. Critical of the FSA’s performance during the recent financial crisis, the Conservative Party advocated a shift in responsibility for all prudential supervision from the FSA to the Bank of England and replacing the FSA with an agency focused exclusively on consumer protection. In effect, such a proposal would change the nature of the U.K. system from that of a single regulator model, where the FSA is solely responsible for financial regulation, to a twin peaks model, where the Bank of England would be responsible for prudential supervision and the new agency succeeding the FSA would be responsible for consumer protection regulation.

In May 2010, the Conservative Party formed a governing coalition with the Liberal Democrats Party, forcing the Labour Party into opposition. In June 2010, the new Conservative-Liberal Democrats government announced that it would end the tripartite arrangement, offer legislation to shift responsibility for prudential supervision to the Bank of England,

and turn what remains of the FSA into the new Consumer Protection and Markets Authority.\textsuperscript{11}

B. United States

The U.S. Treasury Department’s White Paper on Financial Regulatory Reform, issued in June 2009, laid out President Barack Obama’s Administration’s plan to reform the U.S. financial regulatory system.\textsuperscript{12} The Obama White Paper recommended reforms in five areas: (1) supervision and regulation of financial institutions; (2) regulation of financial markets; (3) consumer and investor protection; (4) resolution authority over bank holding companies and other large financial institutions; and (5) international regulatory standards and cooperation.

In terms of supervision and regulation of financial institutions, the Obama White Paper called for the creation of a Financial Services Oversight Council, composed of the heads of each federal financial regulatory agency. The Council would replace the President’s Working Group on Financial Markets. Furthermore, the Council would have a permanent staff and hold regular meetings, suggesting that the Council would be independent of existing federal agencies and play a leading role in coordinating regulatory initiatives across federal agencies. The Obama White Paper also tackled the problem of institutions that are too-big-to-fail by recognizing a new category of financial institutions called “Tier 1 Financial Holding Companies” (Tier 1 FHC). While under the current system only depository institutions are subject to prudential supervision by the federal banking agencies, any financial institution may be deemed a Tier 1 FHC under the Obama White Paper.\textsuperscript{13} All Tier 1 FHCs would be subject to consolidated supervision by the Federal Reserve, tighter capital adequacy requirements, and higher risk management standards.

In terms of reorganizing the regulatory system, the Obama White Paper’s recommendations were quite modest. It sought to combine the Office of Thrift Supervision (OTS) and Office of Comptroller of the


\textsuperscript{13} Four federal agencies share responsibility for the supervision of banks. The Federal Reserve supervises bank holding companies and certain state-chartered banks that have elected to be regulated by the Federal Reserve. The Office of the Comptroller of the Currency supervises all federally chartered national banks. The Office of Thrift Supervision regulates federal savings associations. The Federal Deposit Insurance Corporation oversees the national deposit insurance system and supervises, in conjunction with state banking regulators, state-chartered banks that are not members of the Federal Reserve System.
Currency (OCC) into a new, single national bank supervisor. The other regulators of depository institutions would remain intact. Supervision of state-chartered banks would continue to be the responsibility of the Federal Reserve and Federal Deposit Insurance Corporation (FDIC). The Obama White Paper further proposed creating a new Office of National Insurance to monitor, but not regulate, the insurance industry.

The Obama White Paper’s other significant proposal was the creation of a new, stand-alone Consumer Financial Protection Agency (CFPA). Excluding investment services already regulated by the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC), the CFPA would regulate the manner in which financial institutions sell credit, savings, payment, and other financial products to consumers. Equally important, the powers of the CFPA would cross institutional lines, allowing the CFPA to impose requirements on depository and non-depository financial institutions. The CFPA also would have supervisory and enforcement authority, making it truly independent from the federal prudential supervisors.

It should be noted that the Obama White Paper represented the second major attempt in two years to reform the U.S. financial regulatory system. In March 2008, Treasury Secretary Henry Paulson, serving under President George W. Bush, put forward the ambitious Blueprint for a Modernized Financial Regulatory Structure.14 The Paulson Blueprint began as an attempt to rethink the regulation of U.S. financial markets in order to make them more competitive relative to foreign financial markets.15 As the financial crisis worsened, the focus of the Paulson Blueprint changed to address growing public concerns about the effectiveness of the U.S. regulatory system.16 Congress, however, never seriously considered the recommendations of the Paulson Blueprint, and Secretary Paulson admitted that many of the recommendations of the Blueprint would take years to implement. By late 2008, the outgoing Bush administration was not in a position to push for such an ambitious overhaul of the U.S. regulatory system.17


16. The Paulson Blueprint, for example, provides a number of short-term recommendations aimed at addressing the downturn in the credit and mortgage markets. See Paulson Blueprint, supra note 14, at 5.

The Paulson Blueprint, however, anticipated many of the regulatory challenges later identified by the Obama White Paper and offered more aggressive solutions to address these challenges. In particular, the Paulson Blueprint tackled the problem of trying to supervise financial supermarkets that did not neatly fall within the categories of banking, securities, and insurance. The Blueprint advocated an “objectives-based approach” where regulatory agencies would be organized in accordance with the relevant regulatory objective (e.g., market stability, safety and soundness, and consumer protection). The Paulson Blueprint recognized the inefficiency of having multiple federal agencies compete to regulate the same type of financial institutions. Such complexity over-regulated certain firms and left other firms under-regulated. Furthermore, the Paulson Blueprint sought to strengthen consumer protection by separating the regulation of business conduct from prudential regulation. As a result, the Paulson Blueprint proposed consolidating the responsibilities of most existing federal agencies into two super-agencies, a Prudential Financial Regulator and a Business Conduct Regulator. The Blueprint also envisioned giving explicit powers to the Federal Reserve to be a market stability regulator. The reforms put forward by the Obama White Paper were comparatively much more modest.\footnote{19}

C. European Union

In November 2008, the European Commission tasked an expert panel chaired by Jacques de Larosière, a senior official of the French Treasury, to address systemic risk. The panel, known as the Larosière Report, recommended creating an EU-wide systemic risk regulator, a single regulator for the financial sector, and a supervisor for non-bank financial institutions. These changes were intended to improve the efficiency and effectiveness of financial supervision and to prevent the recurrence of the financial crisis. The report called for the creation of a new agency, the European Systemic Risk Board, to monitor and address systemic risks, and the adoption of a single Supervisory Authority to oversee banks and other financial institutions. The European Union took action to implement these recommendations, with the establishment of the European Banking Authority (EBA) and the European Systemic Risk Board (ESRB).
to study possible reforms of the EU financial regulatory system.\textsuperscript{20} The panel’s mandate was to consider the weaknesses in European supervision of financial institutions that were revealed by the financial crisis and to recommend improvements to the EU financial supervisory system.\textsuperscript{21} The panel issued its report in February 2009, and the European Commission endorsed the de Larosière Report in March 2009, announcing in May 2009 a desire to implement the de Larosière recommendations.\textsuperscript{22} In September 2009, the European Commission proposed legislation to create two new European bodies: the European Systemic Risk Board (ESRB) and European System of Financial Supervisors (ESFS).\textsuperscript{23}

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\textsuperscript{21} See id.


\end{flushleft}
The ESRB would be responsible for monitoring and identifying systemic risks that may adversely affect the EU financial markets. Before the creation of the ESRB, each individual EU member state handled systemic risk regulation, but the de Larosière Report noted that national regulators were ill-positioned to identify systemic risk events that originated outside their jurisdictions.\(^{24}\) The ESRB would carry out an information gathering function, having no powers of its own to respond to systemic risk threats.\(^{25}\) Instead, the ESRB would issue recommendations to member states and expect the member states to pursue the correct course of action or explain why they ignored the ESRB’s recommendations.\(^{26}\) Central bankers also would dominate the ESRB. The European Commission concluded that central banks are in the best position to be systemic risk regulators, given their experience and expertise in monitoring economic trends to effect monetary policy.\(^{27}\) The European Commission recognized the importance of giving the ESRB access to information about financial institutions and financial markets.\(^{28}\) Therefore, senior representatives of the national supervisory authorities would be invited to attend ESRB meetings as observers. Full members of the ESRB would include the President and Vice President of the European Central Bank, a representative of the European Commission, and the chairmen of the various European Supervisory Authorities that compose the ESFS.

The ESFS, on the other hand, would be responsible for coordinating the supervision and regulation of individual financial institutions. The ESFS would be composed of three European Supervisory Authorities (ESAs): the European Banking Authority, the European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority. These authorities would replace the current Committees of Supervisors, such as the Committee of European Securities Regulators, established as part of the Lamfalussy process.\(^{29}\) Like the Committees of Supervisors, the ESAs would continue to serve as coordinating bodies for national regulators, working to harmonize rules and standards across

25. It should be noted, however, that the President of the European Central Bank (ECB) is the chair of the ESRB, and the ECB does have some direct power to intervene in the financial markets.
26. The requirement on member states to justify their rejection of an ESRB recommendation represents adoption of the “comply-or-explain” strategy used in the United Kingdom and other jurisdictions. Such strategy places a reputational burden on the non-complying party as they have to explain their reasons for disagreeing with the recommendation. See Sanjai Bhagat et al., The Promise and Peril of Corporate Governance Indices, 108 Colum. L. Rev. 1803, 1864-65 (2008) (describing comply-or-explain regulation strategy).
27. See European Commission May Communication, supra note 22, at 6.
28. See id.
member states. In addition, the European Supervisory Authorities would have new powers to collect information, issue binding technical standards, and assume supervisory responsibility for certain financial institutions that operate across the European Union. Membership in the European Supervisory Authorities would remain the same as that of the Committees of Supervisors.

The principle behind the creation of ESRB and ESFS is to facilitate coordination and develop common standards of financial regulation among the member states. The regulatory reforms proposed by the de Larosière Report and the European Commission are consistent with the European Union’s long standing desire to encourage harmonization of rulemaking and standards-setting at the European level. To this end, the ESRB and ESFS, as envisioned by the de Larosière Report, represent a substantial shift in regulatory power away from member states and to the European Union. While member states may retain direct powers over their markets and local financial institutions, these EU-level bodies would limit member states’ abilities to effect regulation that is not first discussed or debated at the EU-level. As a result, the implementation of the de Larosière Report recommendations offers an important model for how cross-border regulation and supervision may be conducted.

III. FOUR CHALLENGES TO FINANCIAL REGULATORY REFORM

The three jurisdictions have taken quite different approaches toward financial regulatory reform. One explanation for the differences is politics. In the United Kingdom, for example, the FSA is closely associated with the current Labour Government, having been one of the first legislative achievements of the Labour Government after its assumption of power in 1997. The Conservative Party, however, has felt free to challenge the competency of the FSA and to advocate the agency’s abolishment. In the United States, the Obama Administration prepared its White Paper with the expectation of having difficulty attaining congressional approval of implementing legislation. As expected, various parts of the White Paper have been attacked by both right and left leaning members of Congress. The Obama Administration also faced the problem of win-

30. The ESAs are also more powerful than their predecessors, the Committee of Supervisors, in two respects. First, while decision-making in the Committee of Supervisors was by consensus, decision-making in the ESAs will be by Qualified Majority Vote (QMV). The introduction of QMV will greatly enhance the reach of the ESA’s rulemaking powers. Second, the proposed legislation has included a dispute resolution provision to resolve disagreements between national regulators.


Challenges to Financial Regulatory Reform

ning congressional support for its reform proposal while seeking congressional support for a number of its other major legislative initiatives—most notably health care reform. As a result, the Obama White Paper can best be described as a product of political realism rather than an ideal roadmap for financial regulatory reform. Finally, the European Union remains limited by its ever-present challenge of balancing expansion of EU-level institutions with the sovereign interests of its member states.33

Another explanation is that each jurisdiction approached regulatory reform from different assumptions about the best way to regulate the financial markets. The United Kingdom already had in place a single financial regulator and a central bank focused on setting monetary policy. Therefore, the focus of the reform debate in the United Kingdom was on the relationship between the FSA, the Bank of England, and HM Treasury, and on the sharing of prudential supervisory responsibility between the FSA and Bank of England.

In contrast, the United States has had a regulatory system where power is divided among federal and state agencies and, at the federal level, among several federal agencies. A state-chartered bank could be subject to supervision by its home state bank regulator as well as by the FDIC or, if it so chooses, the Federal Reserve. In addition, regulatory agencies divided up responsibility amongst themselves based on the type of activity carried out by the type of institution.34 For example, one group of agencies would regulate banks, another agency would regulate securities firms, a third group of regulators would regulate insurance providers, and so forth. Thus, reform of the U.S. regulatory system means changing years of regulatory practice and challenging entrenched institutional interests.

The European Commission has a relatively blank slate as the current EU-level financial regulatory institutions are in their infancy, but it is still constrained by the fact that it must ensure the EU-level framework is compatible with the regulatory systems of the various member states. Some member states follow a single regulator model; others follow a twin-peaks approach.35 Some states have complex financial regulatory systems, reflecting the advanced nature of their financial markets; other states have less advanced regulatory frameworks. Thus, the European Union must have a regulatory framework flexible enough to respect the different national systems of regulation and the characteristics of the various European markets.

The most important explanation of why the United Kingdom, United States, and European Union have adopted different approaches to regulatory reform, however, is that the jurisdictions disagree regarding how to

34. See Pan, Structural Reform, supra note 5, at 20-21.
35. See, e.g., id. at 29-50.
respond to the four basic challenges to financial regulatory reform—determining: (1) how should regulatory systems be structured; (2) should there be a separation of prudential supervision and consumer protection regulation; (3) which entity should be responsible for monitoring and managing systemic risk and what should be its powers; and (4) how should cross-border financial services and transactions be supervised and regulated?

A. Structure of Financial Regulatory Systems

Each proposal recommended some reorganization of the jurisdiction's previous regulatory structure. HM Treasury in the United Kingdom proposed a new Council for Financial Stability to manage the relationship between the FSA and the Bank of England. The opposition Conservative Party advocated the shifting of supervisory responsibility from the FSA to the Bank of England, and the subsequent replacement of the FSA with an agency focused entirely on consumer protection. The Obama White Paper argued for consolidation of the smaller federal bank regulatory agencies, OCC and OTS, the creation of a consumer financial protection agency, and the establishment of an office within the Treasury Department focused on monitoring state insurance regulation and negotiating international agreements on insurance. The European Commission sought to create a new EU-level committee focused on providing systemic risk oversight and to reorganize EU-level prudential regulators into more powerful European financial supervisors for securities, banking, and insurance.

In a previous article, I argued that the key characteristics of an optimal regulatory system are efficiency, accountability, competency, and legitimacy. We want our regulatory system to be efficient in its collection of information and allocation of regulatory resources. We want our regulatory system to be accountable for regulatory failures. We want our regulatory system to be competent in managing regulatory problems. Regulators must have the necessary expertise and experience in the areas they are being asked to regulate. And we want our regulatory system to be legitimate in the eyes of the market actors who the regulators must monitor and influence.

The organization of the regulatory system plays a significant role in determining the characteristics of the regulatory system. Any decision to reorganize a regulatory system must take into account two factors. The first factor is whether the arrangement of existing agencies suits their regulatory responsibilities. An agency's existence must serve a particular regulatory purpose. Unnecessary or duplicative agencies should be eliminated or pared back, and new agencies should be established, or old agencies expanded, where there are gaps in the regulatory system. This line of inquiry is particularly apt when considering a complex regulatory

36. See id. at 11-14.
system like that of the United States' where several agencies share responsibility for supervising banks and have similar objectives. In such cases, consolidation of agencies may be desirable as it is often inefficient to have competing regulators serve the same "clients." Similarly, reducing the number or size of agencies may be problematic if it reduces regulatory coverage. The remaining agencies must be ready to accept broader responsibilities to achieve complete oversight.

The second factor is whether multiple agencies have adequate resources. Resources refer not only to budget and personnel, but also to access to information. The danger of dividing regulatory responsibility among several agencies is that a single agency may find itself under-resourced, limiting its ability to accomplish its regulatory mission. Thus, even when multiple agencies share responsibility for regulating the same institutions or market areas, giving the impression of sufficient regulatory oversight, it may be the case that no agency has the capability to carry out its regulatory responsibilities in an effective manner or, in an attempt to conserve resources, defines its lines of responsibility too narrowly (i.e., regulatory myopia), exacerbating the problem of inadequate regulatory coverage noted earlier.37

In general, consolidation of regulatory agencies is desirable. Fewer agencies mean better allocation of resources and fewer opportunities for regulatory gaps. But how far should jurisdictions pursue consolidation? The extreme case is the single regulator model, epitomized by the United Kingdom's FSA.38 A single regulator is attractive because there is no division of resources or regulatory responsibility among smaller regulatory agencies.39 As the U.K. experience with the FSA shows, however, a single regulator may just internalize many of the problems faced by a more fragmented regulatory system.40 Discussions concerning allocation of resources and setting of regulatory priorities shift from the public sphere to

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37. It should be noted that smaller agencies may have some advantages. One can argue that smaller agencies are more competent in carrying out their duties because of their narrower focus and, consequently, deeper expertise, or that they are more vigorous regulators because of competitive pressure from other agencies. See Richard J. Rosen, *Is There a Crowd? Competition Among Regulators in Banking*, 35 J. Money, Credit & Banking 967 (2003) (arguing for benefits of bank regulator specialization).


40. The FSA's internal audit of its supervision of Northern Rock revealed that business units within the FSA operated independently of each other and failed to share information with more qualified personnel in other business units. This lack of coordination contributed to the FSA's failure to understand the risks associated with Northern Rock's operations prior to Northern Rock's request for emergency liquidity assistance. See *Financial Services Authority, Internal Audit Division*,
the private sphere within the single regulator, reducing transparency and limiting public oversight.

Consolidation is most beneficial when it eliminates the silo or institutional approach to regulating financial institutions. In the institutional approach, multiple regulatory agencies exist to oversee particular categories of financial institutions. For example, a jurisdiction may have one group of regulatory agencies overseeing securities firms, another group overseeing banks, and a third group overseeing thrifts. This approach, however, has proven out-dated as many financial firms pursue a variety of financial services and activities that defy the traditional categories of securities, banking, and insurance. As a result, consolidation is necessary because existing regulatory agencies no longer match the types of financial institutions they are supposed to be supervising. Consequently, they often find themselves working at cross-purposes to their sibling agencies.

In this respect, both the U.S. and EU approaches are lacking. The Obama White Paper does not go far enough in pursuing regulatory consolidation. The U.S. system continues to follow an institutional regulatory approach, leaving intact a multitude of regulatory agencies that are regulating different institutions, but the same type of financial activity. The Obama White Paper's attempt to address the problem of large financial supermarkets can be best described as a "sweep under the rug" strategy where the largest of such institutions are given special status as Tier 1 FHCs and then subject to oversight by the Federal Reserve. Aside from the issue of whether the Federal Reserve is the best agency to supervise these financial institutions, the White Paper does not justify the need for additional prudential supervisors if the Federal Reserve can successfully carry out complete supervision of the largest and most complex financial institutions. Why should institutions that fall below the definition of Tier 1 FHCs still be regulated by other agencies and, for that matter, multiple agencies?

Adherence to the institutional approach also undermines the effectiveness of the EU reform proposal. The European Union continues to divide regulatory responsibility along the lines of a securities supervisory authority, a banking supervisory authority, and an insurance supervisory authority. The European Union should instead consider a single European Supervisory Authority and eliminate narrow regulatory approaches.

B. Logic of Twin Peaks

The second challenge that the regulatory reform proposals must address follows directly from the question of the optimal number of regula-
tory agencies. If policymakers consider reducing the number of regulatory agencies to improve efficiency, accountability, and legitimacy, should prudential supervision and consumer protection be handled by separate agencies? At issue is whether we should accept the logic of twin peaks. Twin peaks refers to the view best put forward by Michael Taylor, who asserted that the optimal regulatory structure is two separate agencies, one focused on prudential supervision and regulation and another focused on consumer protection and business conduct regulation.\(^{42}\) The logic is that there is a fundamental difference between prudential regulation and those of consumer protection regulation—differences that encourage a separation of the two regulatory activities. In the case of prudential regulation, the regulator pursues a cooperative relationship with the financial institution. The regulator’s role is to assist financial institutions in protecting their financial condition. It sets standards and monitors the maintenance of those standards by the financial institution. To the extent a financial institution fails to meet certain standards or the regulator identifies a possible threat to the safety and soundness of the financial institution, the regulator’s task is to raise its concerns with the institution and work with the financial institution to identify and implement a solution. In contrast, a consumer protection regulator is primarily in an adversarial position relative to financial institutions. The regulator’s role is to protect consumers and investors against the financial institutions. Consequently, the regulator uses its rulemaking powers to impose new requirements on financial institutions and its enforcement powers to discipline and punish financial institutions for conduct violations. These differences require prudential and business conduct regulators to invoke different strategies and approaches, justifying the separation of prudential supervision and consumer protection into different agencies.

The alternative to the twin peaks model is where the same regulators handle prudential supervision and consumer protection. A single financial regulator represents the ultimate consolidation of both prudential supervision and consumer protection responsibilities in the hands of a single agency. Assuming there is no separation of the two regulatory functions in the internal structure of the agency, the single regulator model represents a rejection of the logic of twin peaks.

The question of whether the logic of twin peaks is valid arises in the U.S. and U.K. proposals to create standalone agencies dedicated to consumer protection. In the United Kingdom, the Conservative Party recommended that the FSA be replaced with a consumer protection agency. In the United States, the Obama White Paper proposed the creation of the CFPA. The call for stronger consumer protection regulation stems from lessons drawn from the recent financial crisis. The housing price bubble

resulted in part from widespread access by consumers to cheap mortgage products, such as adjustable rate mortgages with low teaser interest rates. At the same time, the widespread availability of inexpensive credit encouraged high levels of consumer spending and increased levels of household debt. When housing prices began to fall, mortgage and other loan default rates increased as consumers found themselves unable to meet their obligations. In certain cases, consumers declared themselves unaware of the true financial cost of some of the loans that they accepted so easily when the market was more robust. While consumers bear much responsibility for taking on such high levels of debt, there is also the recognition that the financial industry, ranging from mortgage lenders and credit card companies to investment advisers and brokers, benefited from selling products and services to unsophisticated consumers, charging these consumers high fees and commissions. As a result, there have been calls for tougher consumer protection laws and an agency devoted to the promulgation and enforcement of consumer protection regulation.  

The recent financial crisis supports the logic of twin peaks. In the run up to the financial crisis, regulatory agencies in the United States and United Kingdom demonstrated little concern for the needs of consumers to better understand the financial services and products that they purchased. The Federal Reserve, for example, elected not to conduct consumer compliance examinations of certain bank holding companies as far back as the late-1990s despite complaints raised by advocacy groups about abusive lending practices to low income families. The Federal Reserve's past performance raised concerns about the ability of a single agency to balance appropriately its twin regulatory objectives.

In promoting a new, independent consumer protection agency with powers that extend across the banking and nonbanking financial sectors, the Obama White Paper represents an endorsement of the logic of twin peaks. In the United Kingdom, the FSA and HM Treasury, however, appear reluctant to accept the logic of twin peaks, rejecting the Conservative Party's call for a separate consumer protection agency. At the same time, the European Commission has not suggested any structural reforms to promote independent consumer protection agencies. To the extent that consumer protection is vital to ensuring a sound financial market, policymakers must consider the validity of the twin peaks model.

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C. Powers and Identity of the Systemic Risk Regulator

The United Kingdom, United States, and European Union also face the challenge of deciding the appropriate role of the systemic risk regulator and who should fill this role. During the financial crisis, there was a loss of confidence in the ability of certain financial institutions to meet their obligations, leading to a credit market freeze and deleveraging. This loss of confidence resulted from the massive losses that the largest financial institutions reported. These institutions mismanaged their investment portfolios and allowed themselves to be overexposed to the subprime mortgage market. Regulators were unprepared for these events because they did not carefully monitor the economic and financial market trends to see the growing threat to the stability of the financial markets caused by the housing price bubble and the growth of the structured finance product markets.

Why were there no regulatory agencies watching for general threats to the financial system? The Turner Review offered one answer. The Bank of England (like most central banks) focused primarily on monetary policy analysis. Its priorities were to keep inflation rates low and nurture steady gross domestic product growth. The FSA (like most regulatory agencies) concerned itself with the supervision of individual financial institutions rather than oversight of the financial system as a whole.\(^{45}\) Neither agency looked at, or felt it was one of its regulatory priorities to monitor, the general stability of the financial markets.

The creation of a systemic risk regulator, however, poses two problems. First, what powers should a systemic risk regulator have, and, second, who should serve as the systemic risk regulator? In order to carry out its objective, a systemic risk regulator must have the power to compel and collect information about both general economic trends and financial market activities. The power to collect such information alone would make the systemic risk regulator the most powerful agency in a regulatory system.\(^{46}\) Such an agency naturally would need to be able to demand that financial institutions and market intermediaries disclose detailed information about their financial condition, trading activities, and investment portfolios. It would need to have the ability to conduct inspections and mandate financial institutions to follow certain internal control and risk management practices. It would also need to be privy to all of the same macroeconomic data currently collected and reviewed by central banks.

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\(^{45}\) See Turner Review, supra note 6, at 84. Charles Goodhart has noted that in the late 1980s Japanese banks appeared individually strong and robust, but the Japanese banking system was quite fragile when there was a sudden decline in asset prices. See C.A.E. Goodhart, Some New Directions for Financial Stability? (June 27, 2004), in The Per Jacobsson Lecture, June 2004, at 5, available at http://www.perjacobsson.org/lectures/062704.pdf.

\(^{46}\) Some fear that the concentration of monetary policy and prudential supervision in a single agency may create an entity too powerful for political oversight. See Masciandaro, supra note 38, at 163.
making monetary policy. Currently, no single agency in the United States or European Union has the power to compel disclosure of all necessary information required by such a systemic risk regulator.

In addition to the power to collect information, a systemic risk regulator also must have the power to intervene in the financial markets when there is a systemic threat. The tools of intervention would need to be varied and powerful, further increasing the regulator’s authority. On one hand, the systemic risk regulator must have all of the powers of a prudential supervisor. It must be able to set capital adequacy rules and direct individual financial institutions to modify their investment and lending portfolios. Such prudential supervisory powers would be essential to mitigate the moral hazard problem. On the other hand, the systemic risk regulator must have the power to intervene in the markets in a time of crisis. Such power would need to include the ability to serve as lender (or guarantor) of last resort, the power to take over insolvent institutions, and the ability to supply liquidity, extend credit, or make markets.

Central banks in general already have many of the responsibilities and powers consistent with a systemic risk regulator. They monitor the condition of the general economy and serve as a lender of last resort. They also have the resources to intervene in the financial markets. Most central banks, including the European Central Bank and the Bank of England, however, do not have supervisory capabilities. In these jurisdictions, separate prudential supervision agencies handle the task of financial institution supervision.

Alternatively, the main prudential supervisor could serve as the systemic risk regulator. This alternative is most attractive when there is al-


48. One of the challenges of the systemic risk regulator is to set capital adequacy rules based upon the collective risk of failure rather than only on the risk of failure of the individual bank. See, e.g., Viral V. Acharya, A Theory of Systemic Risk and Design of Prudential Bank Regulation, 5 J. FIN. STABILITY 224 (2009).


50. See, e.g., Roger W. Ferguson, Jr., Should Financial Stability Be an Explicit Central Bank Objective?, in CHALLENGES TO CENTRAL BANKING FROM GLOBALIZED FINANCIAL SYSTEMS 208 (Piero C. Ugolini et al. eds., 2003) (noting that one of fundamental objectives of central banks is to ensure financial stability).

51. See Goodhart & Schoenmaker, supra note 49, at 544, 558. The number of separated monetary and supervisory agencies is greater than Goodhart and Schoenmaker originally recorded. With the introduction of the euro in 1999, the European Central Bank assumed the power to manage monetary policy for the Euro-zone countries (initially Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, The Netherlands, Portugal, and Spain), leaving national authorities only with the responsibility of financial regulation. See Masciandaro, supra note 98, at 159-60 (measuring degree of central bank’s involvement in financial supervision).
ready a single regulator like the FSA. A prudential regulator would be in the best position to understand the conditions of financial institutions and the financial markets. A prudential regulator also has expertise in collecting and analyzing information about market operations. But, prudential regulators have little experience in monitoring general economic and market trends and lack the market intervention powers enjoyed by central banks.

A third alternative would be to make systemic regulation the job of a committee (or "college" or "council") of agencies consisting of the central bank and prudential supervisory agencies. A committee is attractive because it avoids the need to reallocate power among agencies and allows each participant to focus on its area of specialty. The concern is that committees suffer from coordination problems. Committee members may not share information in a timely fashion, the need for consensus may cause a committee to be indecisive and sluggish, and the lack of a lead agency to impose an agenda for decisions and actions may result in the committee operating reactively rather than proactively in addressing systemic threats.

The United Kingdom, United States, and European Union are pursuing a combination of these approaches in identifying which agency should serve as a systemic risk regulator. Under the HM Treasury proposal, the new Council of Financial Stability, chaired by the Chancellor of the Exchequer, would monitor systemic risks, but it does not promote either the Bank of England or the FSA as the primary systemic risk regulator. Instead, the HM Treasury White Paper recommended giving the FSA greater prudential supervisory powers over the financial institutions and making it explicit that one of the FSA's statutory objectives is to protect financial stability. At the same time, HM Treasury wanted the Bank of England to assume greater responsibility for monitoring general threats to financial stability and, as part of its new mandate, the Bank of England would publish a semi-annual "Financial Stability Report." Thus, the U.K. government (under the control of the Labour Party) sought to retain the regulatory split between the Bank of England and the FSA, relying on a new tripartite committee structure to ensure coordinated systemic risk regulation. The opposition Conservative Party, on the other hand, advocated transferring responsibility for prudential supervision of financial institutions exclusively to the Bank of England. This proposal would give the Bank of England all of the powers necessary to serve as the United Kingdom's only systemic risk regulator.

The European Commission submitted legislation to assign the task of systemic risk regulation in the European Union to the newly created ESRB. The ESRB would be a committee consisting of national representatives and EU-level officials. Central bankers would outnumber the prudential regulators in the ESRB. What is notable about the ESRB is that the only voting members of the ESRB are central bankers with the exception of the chairs of the three European Supervisory Authorities. Representa-
tives from the member state prudential supervisors would have only observer status. By emphasizing the power of central banks to safeguard the stability of the financial markets, the European Commission apparently concluded that systemic risk regulation consists primarily of crisis management and response. The European Commission did not design the ESRB to prevent or otherwise monitor financial risk that may produce a crisis. The prudential supervisors who operate through the ESFS have the task of ensuring the safety and soundness of the European Union’s large financial institutions.

In contrast to the EU approach, which emphasizes systemic crisis response, the U.S. approach to systemic risk regulation, as articulated in the Obama White Paper, emphasizes prudential supervision and the prevention of systemic risk events. Like the United Kingdom and European Union, the United States would conduct systemic risk regulation by committee—the Financial Services Oversight Council, chaired by the Treasury Secretary. In practice, however, the primary U.S. systemic risk regulator would be the Federal Reserve. In contrast to many of its foreign counterparts, the Federal Reserve is not only a central bank, but also a bank supervisor. As a result, the Federal Reserve is uniquely positioned to prevent, monitor, and respond to systemic risk events.52

The Obama White Paper proposed to strengthen systemic risk regulation by increasing the Federal Reserve’s powers of prudential supervision. First, all financial institutions of a certain size or level of interconnectedness would be classified as Tier 1 FHCs. These financial institutions do not have to be depository institutions. Rather, they only need to be firms whose size and connections to other firms make them systemically important. Second, all Tier 1 FHCs would become subject to consolidated supervision by the Federal Reserve. Working through the Financial Services Oversight Council, the Federal Reserve would have the power to demand reports from the Tier 1 FHCs, set prudential standards applicable to Tier 1 FHCs, restrict the activities of Tier 1 FHCs, and regulate any subsidiaries of Tier 1 FHCs. The Obama White Paper made clear that these prudential standards and requirements would be stricter than what is already imposed on non-Tier 1 FHC bank holding companies.

The approaches of each jurisdiction to the problem of systemic risk regulation are not surprising when considered in the context of the jurisdictions’ different experiences in the recent financial crisis. From the perspective of the Continental European countries, the financial crisis began offshore, and they mainly faced the problem of attempting to limit the effects of the crisis on their domestic financial markets. As a result, the European concern with systemic risk regulation focuses on crisis response. From the perspective of the United States, the financial crisis was the result of adverse market events at home that devastated several large U.S. financial institutions. Crisis response is not viewed as the problem. In fact, one may argue that the U.S. Treasury and Federal Reserve acted decisively and effectively in supporting important financial institutions and avoiding a widespread market meltdown. Instead, U.S. policymakers view the financial crisis as a failure of prudential regulation. Consequently, the U.S. approach toward systemic risk regulation focuses on tougher supervision of those firms deemed too-big-to-fail. The United Kingdom, under the Labour government, was in the middle. Its experience with the financial crisis is similar to that of the United States. At the same time, the United Kingdom already concentrates prudential supervision in the hands of a single, powerful regulator. Thus, the Labour government was, not surprisingly, reluctant to move around the deck chairs when there is no reason to believe the Bank of England would do a better job than the FSA in supervising large financial institutions. Instead, the U.K. government proposal sought to give the FSA more tools to improve its supervisory efforts. The new Conservative-Liberal Democratic government, however, appears to take a different stance in favoring the consolidation of central banking and prudential supervisory responsibilities in the Bank of England.

The U.S. approach (as well as the approach just announced by the new U.K. government) offers the greatest chance of success. A successful systemic risk regulator must have the powers of a prudential regulator and a central bank. The U.S. approach generally consolidates such power in the Federal Reserve as opposed to dividing up systemic risk regulation among multiple agencies. Some critics of the Obama White Paper question whether the Federal Reserve is the right agency to serve as the systemic risk regulator. Leaving aside the management challenge of

53. Consider, for example, the de Larosiére Report’s analysis of the causes of the financial crisis. While the report acknowledges the need to improve prudential regulation in both Europe and the United States, it makes clear its view that the crisis began in the United States and was the product of U.S. policies and market developments. See de Larosiére Report, supra note 22, at 7-12.

54. For discussion of the Conservative-Liberal Democratic government’s approach, see supra note 11 and accompanying text.

leading such a large agency, it is questionable that a council of regulators could carry out the functions of a systemic risk regulator better than a single agency and, even if the Federal Reserve is not that agency, there should be another agency that assumes the role.

One cautionary note, however, should be struck about making central banks serve as systemic risk regulators. The larger the role that central banks play in supervising the operations of financial institutions and providing support to troubled institutions, the greater the degree to which they subject themselves to calls for greater political oversight.\textsuperscript{56} Central banks, however, prize their independence and institutional secrecy. Such characteristics are essential to their role as monetary authorities and lenders of last resort.\textsuperscript{57} Consequently, for many central banks the assumption of responsibility for prudential supervision and monitoring systemic risk may be a poisoned chalice.\textsuperscript{58} Policymakers need to be aware of this problem and balance the need for public oversight with the unique requirements of central banks.

D. \textit{International Cooperation and Cross-Border Regulation and Supervision}

The fourth challenge of financial regulatory reform is achieving international cooperation for cross-border regulation and supervision. At their summits in London and Pittsburgh in 2009, the G-20 leaders recognized

\begin{quote}


58. Goodhart and Schoenmaker have long noted that central banks risk their reputations when they assume responsibility for prudential supervision.

Moreover, there may often be a gap between the expectations of the public about the role of a banking supervisor, i.e., that no-one should ever lose part of their deposit as a result of a bank failure, and the objective of the supervisors, i.e., to prevent systemic collapse and to alleviate asymmetric information by the partial protection of ill-informed clients. Consequently, it has been argued that the reputation of the central bank is more likely to suffer than to benefit from the joint conduct of both functions. The potentially adverse reputational effect on the central bank as an institution that may, almost necessarily, be incurred as a consequence of conducting banking supervision is now becoming widely recognised, at least among central banks.

Goodhart & Schoenmaker, \textit{supra} note 49, at 548.
\end{quote}
that financial crises can no longer be assumed to remain local. As a result, cooperation among national supervisors is necessary to regulate and supervise financial institutions that operate and provide services across borders and to respond quickly and effectively to systemic risk events. What remains unanswered is how such an improvement in international cooperation can be achieved.

The need for greater international cooperation and stronger cross-border regulation and supervision begins with the problem of home versus host country supervision. Oversight of multinational financial institutions generally follows the principle of consolidated home country supervision. For instance, the Icelandic Financial Supervisory Authority (IFSA) had responsibility for supervising the consolidated operations of Icelandic banks and their branches in foreign countries. Regulators in host jurisdictions relied on the IFSA, as home country supervisor, to monitor the soundness of these banks. To the extent that host jurisdictions accepted consolidated home country supervision, financial institutions were able to expand aggressively and offer a range of services to clients outside their home jurisdiction.

Since the recent financial crisis, certain host country supervisors have questioned the ability of home country supervisors to adequately supervise foreign branches and to protect the interests of foreign customers. In the Turner Review, for example, the FSA called for host country supervisors to play a more significant role in supervising local branches of foreign institutions.


60. See generally Basel Committee on Banking Supervision, Principles for the Supervision of Banks' Foreign Establishments 1, 4 (1983), available at http://www.bis.org/publ/bcbs312.pdf. For further discussion of this point, see infra note 68 and accompanying text.


The failure of the Icelandic banks has demonstrated that current arrangements, and in particular the current home/host framework of sharing supervisory responsibility are unsustainable. As a reminder, the current arrangements combine branch passporting rights, home country supervision and purely home-country based deposit insurance. This setup, using the Icelandic banking crisis as an example meant that Landsbanki was free to operate in the United Kingdom as a branch over which the FSA only had limited powers, as responsibility for its prudential supervision rested with the Icelandic regulator. U.K. depositors were also later dependent on the Icelandic deposit insurance scheme, with resources that proved inadequate and requiring the intervention of the U.K. authorities.

Id.
financial institutions. Host jurisdictions' desire to supervise foreign financial institutions stems from their interest in protecting the impact of a financial institution's failure on domestic consumers, investors, and counterparties.

Weakening or abandoning the principle of home country supervision, however, could lead to market fragmentation and higher regulatory costs. If host country supervisors refuse to defer to the home country supervisor, cross-border financial institutions will find themselves subject to oversight by multiple supervisors. As the interest of each national supervisor will be to ensure that a financial institution maintains adequate capital in its local branch at all times or, in a developing crisis, refuse to allow a bank to transfer capital from one branch to another in a foreign jurisdiction, the effect of host country supervision would likely be to force all branches to operate as bank subsidiaries, separately regulated and capitalized. Such an effect would make it difficult for financial institutions to conduct business across borders and stifle international financial markets, to ensure efficient capital allocation between branches.

The best way to avoid the problems associated with host country supervision is to ensure intensive cooperation among national supervisors. This degree of cooperation would require a greater commitment by national supervisors to work with their foreign counterparts than what has been shown to date, and ultimately would require a commitment to supporting new and more powerful international administrative regimes.

Cross-border supervision and regulation consists of two tasks: harmonization and cooperation. Harmonization refers to the task of narrowing differences between national regulatory regimes. Such acts include agreeing upon rules and establishing common standards. Harmonization, however, is a static process. Progress on harmonization takes place on a periodic basis through informal and formal agreements and works best when regulators are attempting to agree on an ex ante rule that must be implemented across jurisdictions. International bodies, such as the Basel Committee or the International Organization of Securities Commissions

62. See Turner Review, supra note 6, at 100-01.

63. Implicit in the principle of home country supervision is the notion that a bank's capital will be transferred between jurisdictions as necessary to meet local demands. During the recent financial crisis, however, concerns about multi-jurisdictional demands on a failing bank's dwindling assets incited host regulators to freeze assets to ensure sufficient capital remains to pay off local obligations. See, e.g., Press Release, HM Treasury, Landsbanki, Heritable, and Kaupthing Singer and Friedlander (Oct. 9, 2008), available at http://www.hm-treasury.gov.uk/press_103_08.htm. Such acts undermine the home country regulator's ability to offer credible supervision of the bank.

64. During a crisis, host country supervisors would be in a competitive position relative to other supervisors. See Eugenio Cerutti et al., How Banks Go Abroad: Branches or Subsidiaries?, 31 J. BANKING & FIN. 1669, 1670 (2007).

65. See Pan, Challenge, supra note 3, at 1; see also David Zaring, International Institutional Performance in Crisis, 10 CTY. INT'L L. 475 (2010) (analyzing performance of existing international law institutions in recent financial crisis).
(IOSCO), that host meetings of national representatives play a crucial role in lowering the cost of regulatory coordination and harmonization.\textsuperscript{66}

Cooperation, on the other hand, refers to a more dynamic relationship between regulators. Cooperating regulators do not operate independently of each other. Rather they are co-dependent. They must share information in real-time and make decisions in consultation with one another. Cooperation describes a relationship that is better suited to the task of supervising financial institutions as opposed to making rules and agreeing upon supervisory standards.

One proposal to promote cooperation by national regulators regarding the supervision of cross-border financial institutions is a college of supervisors.\textsuperscript{67} Such a college would consist of representatives of each host country supervisor with a lead role reserved for the home country supervisor. The success of such an arrangement depends on the willingness of national supervisors to share information with each other, the efficiency of decision-making, and ability to enforce implementation of college decisions. Past attempts at having a college of supervisors oversee multi-jurisdictional financial institutions have had mixed results, and ironically the push to strengthen home country supervision stemmed from the perceived failures of one such college of supervisors.\textsuperscript{68} Thus, there are reasons to be skeptical that colleges of supervisors will generate the level of cooperation needed to effectively oversee large, cross-border financial institutions.


\textsuperscript{67} See \textit{Turner Review, supra} note 6, at 97-99 (endorsing Financial Stability Forum's proposal for colleges of supervisors to regulate cross-border financial institutions).

\textsuperscript{68} A college of supervisors, consisting of representatives from several countries in which BCCI operated, including the United Kingdom, Pakistan, Luxembourg, and the Cayman Islands, oversaw BCCI. The Basel Committee faulted the college for absence of leadership and problems in coordination and communication between regulators about BCCI's international operations and proposed new standards that emphasized the role of the home country in providing consolidated supervision. See \textit{Basel Committee, Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishment} 3, 7 (1992). In 1997, the Basel Committee published the "Core Principles for Effective Banking Supervision," which provided more guidance on the supervision of multi-jurisdictional bank holding companies. The home country supervisor of the bank parent is responsible for monitoring the risk exposure and capital adequacy of the bank group. See \textit{Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision} (1997), available at http://www.bis.org/publ/bcbs30.pdf.
I make two very preliminary observations about how to establish a stronger cooperative relationship between regulators. First, the optimal conditions for cooperation between regulators occurs when there is a pre-existing mutual understanding between regulators that comes about through familiarity with each other's regulatory frameworks, markets, and regulatory approaches. Thus, it is more likely for regulators to cooperate in an effective manner if they focus on developing bilateral, as opposed to multilateral, cooperative relationships. Cooperation will best take place if there is both harmonization of standards (i.e., coordination as a prerequisite of cooperation) and commonality of regulatory interests and philosophies. To this end, the logical partner of the United States is the European Union. Furthermore, given the size of the U.S. and EU financial markets, any cooperative regulatory framework relationship that develops between the United States and European Union will set the dominant framework for prudential supervision of cross-border institutions for the rest of the world.

Second, even strong bilateral cooperation would be second-best to an international administrative body. An international administrative body would serve as a global prudential regulator with powers to reach across

69. See Pan, *Challenge, supra* note 3, at 1.

70. An example of the challenges that underlie efforts to promote regulatory cooperation is the recent attempt by the SEC to negotiate mutual recognition arrangements with Australia, Canada, and the European Union concerning the supervision of broker-dealers and exchanges. The mutual recognition arrangements would have allowed foreign broker-dealers to provide investor services based upon home country supervisory approvals. As a precondition to granting mutual recognition treatment to a foreign firm, the SEC had to determine whether the laws and regulations of the home country were "substantively comparable" to U.S. laws and regulations and whether the home country regulator had oversight powers and a regulatory and enforcement philosophy "substantively similar" to the SEC's. The SEC had difficulty making such a successful determination for more than a handful of countries. See Eric J. Pan, *The New Internationalization of U.S. Securities Regulation: Improving the Prospects for a Trans-Atlantic Marketplace*, 5 EUR. COMP. L.J. 73 (2008). The SEC ultimately entered into only one mutual recognition agreement (with Australia). See Press Release, Securities and Exchange Commission, SEC, Australian Authorities Sign Mutual Recognition Agreement (Aug. 25, 2008), available at http://www.sec.gov/news/press/2008/2008-182.htm.


72. Thoughts turn to the mid-1980s when the United States and United Kingdom became frustrated with, and abandoned, efforts to negotiate a single capital adequacy standard through the G-10. They instead entered into a bilateral agreement on a capital adequacy standard. Given the size of the U.S. and U.K. banking markets, the other G-10 countries understood that the U.S.-U.K. capital adequacy standard constituted the de facto global standard. As a result, within a year of the announcement of a U.S.-U.K. agreement, the rest of the G-10 joined negotiations to produce the first Basel Accord. See Ethan Barnaby Kapstein, *Between Power and Purpose: Central Bankers and the Politics of Regulatory Convergence*, 46 INT'L ORG. 265 (1992).
jurisdictional lines. A global body would overcome many of the weaknesses of ad hoc consultations between national supervisors or even a more formal college of supervisors. While such a supranational body remains in the realm of legal fantasy, many have argued the benefits of international bodies.\textsuperscript{73} It is especially helpful to look at the EU proposal of a European-wide supervisory system as a model of international cooperation. The proposed ESAs represent a significant step forward from the non-binding, consensus-based Lamfalussy committees. The ESAs will have rulemaking power, qualified majority voting decision-making, dispute resolution procedures to discipline non-complying members, and a permanent staff of regulators. Such powers represent a transfer of supervisory responsibility and authority away from national regulators to the EU level. The success of the ESAs would offer important lessons for efforts to create a comparable body outside the European Union.

IV. Conclusion

In considering the various reform proposals the United Kingdom, United States, and European Union have put forward, we must consider whether these reforms will be effective in preventing future financial crises. While the reform proposals under consideration neatly address the regulatory weaknesses revealed by the recent financial crisis, they would have benefited from more careful contemplation of the optimal structure of financial regulation. Reorganization of regulatory agencies gives the impression of great change, but such change will be hollow if reorganization is not accompanied by better regulation, supervision, and enforcement.

Already there are reasons to be concerned that policymakers (and their constituents) have become distracted by symbolic changes rather than substantive reform. In the United States, for example, critics of the Obama White Paper have questioned whether it is wise to give the Federal Reserve a greater role in supervising systemically-important financial institutions because the Federal Reserve was slow to anticipate and recognize the weaknesses of Bear Stearns, Lehman Brothers, AIG, and other troubled firms in the recent financial crisis. Similarly, critics of the Turner Review and HM Treasury Report in the United Kingdom have opposed giving more power and resources to the FSA because the FSA by its own admission failed to properly supervise certain major U.K. financial institutions. Many of these critics have suggested transferring responsibility to other agencies or creating new agencies in the hope that new blood will

invigorate the regulatory system. At the end of the day it does not matter which agency in name is responsible for a particular area of regulation. Instead, it is important to ensure that there is an agency responsible and that it receives adequate resources, information, and legal powers to carry out its responsibilities. This is a management challenge.

For purposes of structural regulatory reform it is necessary to understand the function of regulatory agencies, and how they interact with one another and with their foreign counterparts. Such an understanding requires policymakers to confront the four challenges to regulatory reform identified in this Article. The fact that the United Kingdom, United States, and European Union have produced different answers to the challenges outlined in this Article, suggests that much more work needs to be done to complete the task of regulatory reform successfully.