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Financial Regulatory Reform Initiative

Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture

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BIPARTISAN POLICY CENTER

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ABOUT THE FINANCIAL REGULATORY REFORM INITIATIVE

The Financial Regulatory Reform Initiative (FRRI) is co-chaired by Martin Baily and Phillip Swagel. Composed of five task forces, FRRI's goal is to conduct an analysis of Dodd-Frank to determine what is and what is not working along with recommendations to improve the system.

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Executive Summary

The existing structure, or architecture, for regulating financial firms in the United States has evolved over time, largely due to ad hoc responses to financial crises (see Figure 1). In the aftermath of the most recent crisis, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) continued this pattern and made some needed refinements to that structure. These refinements include: the creation of the Financial Stability Oversight Council (FSOC) to facilitate information-sharing and coordination among the various financial regulators; the consolidation of the Office of Thrift Supervision (OTS) with the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve; and the establishment of a new agency dedicated solely to consumer protection, the Consumer Financial Protection Bureau (CFPB).

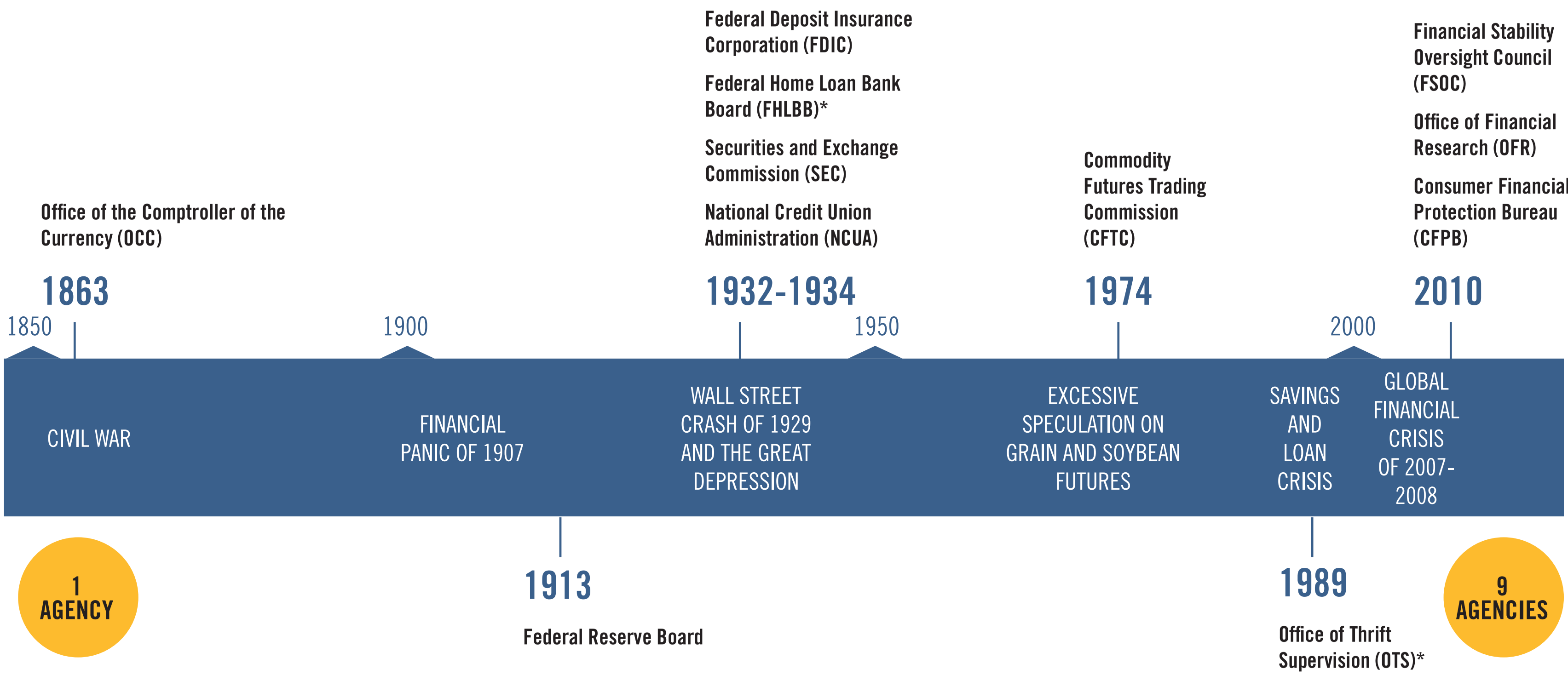
However, certain weaknesses of the U.S. financial regulatory architecture that were highlighted by the crisis either were not addressed or were inadequately addressed by Dodd-Frank. Today, the U.S. financial system remains too fragmented, with gaps in regulation that contribute to systemic risk and inefficiencies in both government and private markets. For example, the separation of securities and commodities regulation creates conflict between agencies and inefficiency for institutions that must comply with two sets of similar rules for similar activities. Likewise, the separate regulation of banks and their parent holding companies can produce regulatory overlap, especially in those cases in which a holding company is in essence a corporate shell for the bank. Furthermore, the United States is one of the few remaining major industrialized countries that does not regulate the business of insurance on a national basis. This complicates coordination with international insurance authorities and impedes national platforms for serving consumers more effectively and efficiently. Finally, the new FSOC is a positive first step toward better regulatory coordination, but it is too large, cumbersome, and weak to effectively coordinate and rationalize the regulatory actions of independent agencies.

Fragmentation in the U.S. financial regulatory structure contributed to the most recent financial crisis. For example, the lack of comprehensive oversight of the mortgage market, from the underwriting process through the securitization of mortgage loans, was at the heart of the crisis. Opportunities for regulatory arbitrage, particularly in the establishment and operation of thrift holding companies, further amplified these problems. Such problems can be substantially mitigated through improvements to the existing regulatory regime.

Past proposals for greater rationalization of the U.S. financial regulatory architecture typically have foundered as a result of three major forces:

1. The natural resistance to changing existing regulatory agencies, both federal and state, because existing stakeholders are familiar and comfortable with the system at the time;

Figure 1. Agency Creation Timeline



*Later abolished

2. Stakeholders unwilling to concede advantages they gain from the status quo, even if such advantages may be inefficient or lead to inequitable treatment; and
3. Jurisdiction divided among multiple congressional committees, each of which historically has been interested in preserving its existing jurisdictional authority.

All of these factors influenced the extent to which Dodd-Frank was able to alter the U.S. financial regulatory architecture. Nonetheless, the task force believes that the financial crisis demonstrated a pressing need for more fundamental reform. Some of these reforms could be phased-in to allow stakeholders to better understand and adapt to the new structure. It is true that past and current political realities make any structural change difficult. That said, the United States needs a financial regulatory system that is both effective and efficient, and one that will not be a significant contributor to the next crisis.

This paper presents a road map for how to achieve a more rational and effective financial regulatory architecture over time in line with important, basic principles. These guiding principles include:

- Clarifying the U.S. regulatory architecture to close gaps that could contribute to a future crisis or financial stress event;
- Improving the quality of regulation and regulatory outcomes;
- Better allocating, coordinating, and efficiently using scarce regulatory resources;
- Ensuring the independence and authority of financial regulators to allow them to anticipate and appropriately act on threats to financial stability; and
- Increasing the transparency and accountability of the regulatory structure.

The task force proposes six major areas in which to improve the quality of the U.S. regulatory architecture and achieve better regulatory outcomes for both financial institutions and the end users of financial services:

1. Improved quality of examinations. Enhance the quality of prudential supervision by taking the following steps:
    a. Create a pilot program, coordinated by the Federal Financial Institutions Examination Council (FFIEC), for a **consolidated examiner force** for insured depository institutions. Over time, such an approach would enhance supervision and improve the caliber of examiners through continuing, specialized training and higher compensation.
    b. **Transition to a consolidated examination force** by combining the prudential banking agencies into a single, unified bank prudential supervisory agency.
    c. Set standards to **improve the compensation of bank examiners**.

d. **Encourage colleges and universities to set up specialized undergraduate and master's degree programs for bank examiners** to raise the profile and skill level of bank examiners as a profession.

2. New architecture. Create a new, consolidated regulatory structure with cleaner lines of responsibility, reduced duplication of efforts, and more effective oversight by both macro-prudential and micro-prudential supervisors with clearer lines of accountability through the following actions:[1]

   a. Create a new **Prudential Regulatory Authority** (PRA) to be the primary micro-prudential regulator and supervisor for safety-and-soundness purposes, including setting basic capital, liquidity, and risk management standards. The PRA would consolidate the supervisory and examination authority of the OCC, FDIC, and Federal Reserve into a unified prudential regulator for all banks and thrifts as well as their holding companies.

   b. Make the Federal Reserve Board (FRB) **the primary macro-prudential supervisor**, responsible for overseeing financial market trends, activities, products, and practices that might pose a systemic risk to financial stability. The FRB would have full access to data on supervision and systemic risk issues through the PRA and Office of Financial Research (OFR), and it would have a backup, macro-prudential supervisory role for all systemically important financial institutions (SIFIs). The FRB would also be the **unified, financial-stability regulator for systemically important non-bank non-insurer financial institutions**, including retaining its role as the primary supervisor for financial market utilities (FMUs).

   c. Preserve the FDIC's primary role as an **insurer and resolution agency**, while retaining its role of backup supervisor for all banks and thrifts for which it insures deposits.

   d. Create a new **Federal Insurance Regulator (FIR)**, the primary responsibility of which would be to improve the regulation and supervision of insurance companies that elect to hold a new national insurance charter to better serve their customers with a nationwide or global platform. This new national charter would be mandatory for insurance companies that are designated as SIFIs and optional for other companies.

   e. **Phase out the thrift charter** in favor of a **single, modern federal banking charter** designed to meet the needs of all consumers of banking products and services on a competitive basis.

   f. Allow the chair of the FRB to **fill vacancies for the position of vice chairman for supervision**, absent a nomination by the president.

3. FSOC and OFR. Give the FSOC and OFR, two new macro-prudential agencies created by Dodd-Frank, the independence and authority necessary to effectively identify and prevent systemic risk.

    a. **Enhance the FSOC's macro-prudential authority** by giving it authority to set minimum heightened standards and safeguards on systemically risky activities and practices for member agencies.

    b. Make joint rule-writing more efficient and timely by **empowering the FSOC to adjudicate rulemaking disputes** among member agencies.

    c. Focus regulators on the most systemically important institutions by **raising the threshold from $50 billion to $250 billion for automatically applying heightened prudential standards to banks**, and by **making the threshold presumptive**.

    d. **Adjust FSOC voting membership** to align the FSOC's mandate more closely with its membership.

    e. **Improve the accountability and transparency** of the FSOC.

    f. **Make the OFR truly independent** and capable of providing objective, timely research and analysis on systemic risk issues to the FSOC, regulators, Congress, and the public by **removing it from the Treasury Department** and establishing it as an independent entity.

    g. Grant **more independence to the FSOC and OFR** by giving them greater control over their budgets.

    h. **Centralize data collection in the OFR** to improve regulatory efficiency.

    i. Improve the ability of regulators to foresee threats to financial stability by **establishing a financial war-gaming center** within the OFR.

4. Capital Markets Regulator. Create a single, modern **Capital Markets Authority** (CMA) to oversee the fair and efficient functioning and competitiveness of U.S. capital markets. The CMA would be established through the merger of the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC).

5. Funding. Give all agencies **independent and appropriate funding** by removing their funding from the congressional appropriations process.

6. Cross-border impact assessments. Mandate that the **FSOC study all rulemakings with cross-border impacts and then make recommendations to Congress and the regulators** that would address impacts on financial stability, economic growth, competitive opportunities, and international cooperation.

The task force's plan is aimed primarily at reforming the federal financial regulatory system, while preserving the best features of the dual banking system that has served the country well for more than 150 years. The reforms proposed to the federal regulatory structure are achievable and consistent with the dual banking system. Moreover, the reforms would benefit state regulators by giving them more options to access and leverage federal resources and avoid unnecessary overlap and duplication.

Taken as a whole, the task force's recommendations will make the U.S. financial regulatory system more efficient, accountable, rational, resilient, and better able to identify and respond to future threats to financial stability and economic growth. The recommendations will close current regulatory gaps and contribute significantly to enhanced safety and soundness of individual financial institutions and the financial system as a whole. They will put the U.S. financial regulatory system more on par with other developed countries' regulators on critical cross-border issues embedded in a global financial system. Finally, by collectively strengthening the U.S. financial regulatory architecture, these recommendations will help ensure that the United States maintains its standing as the world's preeminent provider of financial services.

Introduction

This paper proposes a new structure for the U.S. financial regulatory system. To some, this may seem unnecessary after the 2010 passage of the Dodd-Frank Act, which made significant changes to the U.S. regulatory architecture following the financial crisis. In fact, Dodd-Frank focused more on expanding regulatory authority than making the overall structure more efficient or eliminating overlapping jurisdictions. As one analysis put it, Dodd-Frank "will do little to streamline the fractured financial regulatory framework."[2] In short, it was a missed opportunity.

There are many reasons that the opportunity to rationalize and strengthen the U.S. regulatory structure was missed. Resistance to change and the desire of regulatory agencies, Congress, and the financial industry to protect their existing turf and relationships makes consolidation difficult. For some, other provisions in Dodd-Frank were more important and did not warrant fighting a politically difficult battle to achieve consolidation.

The recommendations in this report are offered in the context of sparking an objective and long-overdue policy debate on the type of financial regulatory architecture that best meets the needs of a dynamic financial system upon which the United States relies for economic growth and job creation.

This aspiration may seem lofty given the number of major proposals to change the U.S. financial regulatory architecture that have foundered over the past few decades. Yet, what is politically impossible today may become feasible when an unexpected financial or market event changes the political dynamics in Washington. This report presents a series of practical recommendations that deserve the attention and consideration of policymakers, financial regulators, and the public at large. In some cases, these recommendations can be implemented by regulators without legislative action, while other recommendations provide new ideas for Congress and other stakeholders to consider. As a whole, these recommendations would substantially improve the performance of the U.S. financial regulatory system, enabling it to support greater financial stability and a dynamic, growing economy.

Roads Not Taken

The financial crisis generated numerous recommendations to reform the U.S. financial regulatory system. Two influential plans from the crisis period were the "Blueprint for a Modernized Financial Regulatory Structure,"[3] written in 2008 by the Treasury Department under then-Secretary Henry M. "Hank" Paulson Jr., and the "Financial Regulatory Reform: A New Foundation" white paper, produced in 2009 by the Treasury Department under then–Treasury Secretary Timothy Geithner.[4] In 2010, Chairman Christopher Dodd of the Senate Banking, Housing and Urban Affairs Committee integrated key concepts from both plans and included additional ideas when he introduced the Restoring American Financial Stability Act (RAFSA), which would have authorized a single, modern bank regulator.[5] Each of these three frameworks influenced the eventual Dodd-Frank legislation that was signed into law in July of 2010, and are discussed in greater detail in Appendix B. However, other recommendations in these reports worthy of greater consideration were largely ignored.

Listed below are several of the more consequential changes contemplated by the Paulson, Geithner, and RAFSA frameworks that were not included in Dodd-Frank. Taken together, these "roads not taken" would fundamentally change America's financial regulatory system. This report draws from several recommendations made by these three plans.

Combined Capital Markets Regulator

Dodd-Frank "missed a great opportunity to merge the SEC and CFTC," said Senator Mike Crapo (R-ID), ranking member of the Senate Banking Committee.[6] Although the Geithner white paper called for the CFTC and SEC to make recommendations designed to harmonize their working relationship, the Paulson Blueprint was the only one of the three plans to recommend merging the two agencies into a single capital markets regulator.

The idea is not a new one. When the CFTC was created in 1974 to be a futures industry version of the SEC, the agency was short on resources and staff compared with the SEC. Conflicts quickly arose, and the two agencies have fought a number of jurisdictional and court battles in the intervening years.[7]

"The existence of a separate SEC and CFTC is the single largest structural defect in our regulatory system," said House Financial Services Committee Chairman Barney Frank when he introduced a bill to merge the two agencies in late 2012, shortly before he retired.[8] Proponents of a merger believe it would help to plug regulatory gaps and streamline rulemaking by unifying functions in one agency.[9] They also point out that the markets regulated by the two agencies have converged as, for example, many securities-based products are now being traded on futures exchanges.[10] Others believe the cultures and philosophies of the two agencies are too different,[11] and a merger would actually add to the number of regulatory requirements on financial institutions. The SEC falls under the jurisdiction of the Senate Banking and House Financial Services committees, while the Senate and House Agriculture committees have jurisdiction over the CFTC. Appropriations for the two agencies are separated into different appropriations subcommittees in the House, while both agencies are funded by a single appropriations subcommittee in the Senate. The resulting and continuing turf battles have made the establishment of a single, modern capital markets regulator in line with most other advanced nations a politically heavy lift.[12]

Single Prudential Regulator

The Paulson Blueprint called for the creation of a new Prudential Financial Regulatory Agency that would place all federal prudential regulation of institutions with explicit government guarantees, including insurance companies that opted for a national charter, under a single roof. The Geithner white paper proposed the creation of a National Bank Supervisor that would combine the responsibilities of the OCC and OTS into a single agency that would supervise all federally chartered depository institutions. While Dodd-Frank did transition many responsibilities of the OTS into the OCC, the Federal Reserve also expanded its supervisory authority over large, systemically important banks.

Some advocate for a “twin peaks” approach wherein financial regulation is managed by two agencies with separate missions and functions: a prudential regulator and a business conduct regulator. The United States mixes a functional approach—where regulators have responsibility for the types of business that institutions conduct—with an institutional approach, where regulation and supervision is divided according to the legal status of regulated institutions.[13] The Paulson Blueprint called for more of a “three peaks” approach that also included market stability responsibilities at the Federal Reserve.

The world’s most economically advanced countries have adopted a variety of approaches to financial regulation, ranging from an integrated approach with a single regulator handling both prudential and business conduct regulation, to more fragmented models like the U.S. structure. While there is no definitive evidence that any one model is better than another, a 2009 paper by Martin Neil Baily (who serves as co-chair of the BPC’s Financial Regulatory Reform Initiative) and Adriane Fresh argues that the most important attribute of a good regulatory structure is the ability for regulators to work together to ensure that the institutions they regulate do not take excessive risks.[14] The paper also suggests that a high level of communication among agencies, well-thought-out consolidation and execution of reform, and sufficient authority for regulators to take effective action in a timely manner are the key characteristics of a sound regulatory regime.

Independent Funding of Agencies

Since the passage of Dodd-Frank, regulatory agencies have been criticized for missing study and rulemaking deadlines and for failing to uncover problem areas like the collapse of MF Global and Bernard Madoff's Ponzi scheme. The SEC and CFTC, both of which have budgets subject to congressional appropriations, argue that they have significantly more work to do in a relatively short period of time, and insufficient funds and staff to fulfill their full range of duties.

Neither the Paulson Blueprint nor the Geithner white paper called for independent funding for the CFTC or SEC, or for the merged entity that the Blueprint proposed.

Increased Federal Insurance Regulation

While Dodd-Frank established the Federal Insurance Office (FIO), Congress, in deference to state insurance regulators, did not give the FIO the power to write rules, regulate insurance companies, or offer a national insurance charter. The Paulson Blueprint went further than Dodd-Frank by recommending the creation of an optional federal insurance charter that would be regulated through an Office of National Insurance (ONI).[15] Under the Blueprint's plan, the federal regulator would have authority to preempt inconsistent state laws and regulations. The Geithner white paper was open to a federal charter, listing six principles under which it would support the creation of a federal insurance regulator.[16]

Legislation also was introduced in Congress to create an optional national insurance charter. The National Insurance Act of 2007—sponsored by Sen. John Sununu (R-NH) and Sen. Tim Johnson (D-SD)—for example, would have established an Office of National Insurance run by a commissioner with the power to supervise, regulate, and register insurance self-regulatory organizations. Among its other provisions, the bill sought to authorize the ONI director to appoint the ONI as receiver for failed national insurers and establish a National Insurance Guaranty Corporation to provide benefits to life insurance policyholders of institutions in receivership.[17]

Phase-out of the Federal Thrift Charter

At one time, banks and thrifts (also known as savings and loans) had quite different missions. Congress created a federal thrift charter in 1933 with the goal of providing more stable financing for residential mortgages. Over time, however, the distinction between banks and thrifts has blurred considerably. The Paulson Blueprint called for a two-year phase-out of the federal thrift charter, because it is "no longer necessary to ensure sufficient residential mortgage loans are made available to U.S. consumers."[18] The Geithner white paper also proposed eliminating the thrift charter, but with no specific time frame.[19]

Evaluation of Dodd-Frank Act Regulatory Architecture Changes

With this background, the task force members sought to determine which structural reforms Dodd-Frank got right, where it needed to go further, and which additional reforms are needed that were not addressed in the Act.

What Dodd-Frank Got Right

The financial crisis revealed a number of glaring gaps and confusing, overlapping jurisdictions within the U.S. regulatory structure. The regulation of the mortgage industry and the securitization of mortgages is perhaps the most glaring example. Dodd-Frank made progress toward rationalizing and filling some of those gaps, but many still remain today.

CREATION OF FINANCIAL STABILITY OVERSIGHT COUNCIL (FSOC)

There was general post-crisis agreement that regulators needed to better coordinate with each other, and improve their ability to diagnose and address systemic threats, particularly those in areas outside of the banking sector that had been less regulated. Composed of ten voting and five non-voting members, the FSOC's purpose is to bring together the knowledge and expertise of federal and state financial regulators with the goal of preventing or mitigating future crises.[20] By adopting the recommendations in this report to improve the effectiveness of the FSOC, the Council has the potential to be one of the more important structural reforms in Dodd-Frank.

CREATION OF THE OFFICE OF FINANCIAL RESEARCH (OFR)

To best perform its systemic risk oversight functions, the FSOC needs access to high-quality information about risks in the financial sector and an independent voice to put such knowledge into the proper context. The OFR was created within the Treasury Department, with limited autonomy, to support the FSOC with just those functions. It is too soon to tell how effective the OFR will be, in part because the agency is still in its formative period, and in part because a definitive judgment on its effectiveness will not be possible until another financial crisis. Nonetheless, as is the case with the FSOC, the task force believes the OFR could function better and recommends several steps toward that end. Like the FSOC, a properly constructed OFR has the potential to be a great asset in helping to keep the U.S. financial system safer and more stable.

CONSOLIDATING CONSUMER PROTECTION FUNCTIONS

Consumer protection functions prior to the crisis were spread across multiple regulatory agencies, which were later criticized for neglecting to use their authority to protect consumers from the toxic mortgage products that proliferated in the earlier part of the 2000s. Critics argued that prudential regulators would always place their safety-and-soundness responsibilities ahead of consumer protection, so the two functions needed to be separated to ensure a strong, consistent regulatory voice for consumers. Dodd-Frank achieved this to a large extent through the creation of the CFPB.

The BPC's September 2013 report that analyzed the early work of the Bureau found areas deserving of praise and other areas where the CFPB could improve.[21] For example, the report cited the CFPB's work in writing rules for qualified mortgages, remittance transfer, and credit card ability-to-pay, as well as the process it followed. In addition, the report remarked favorably on how quickly the CFPB was able to set itself up and meet statutory deadlines. The report recommended changes in the Bureau's process for issuing guidance, its policy of inviting enforcement personnel into the supervisory process, and improving communications with covered entities and partner regulatory agencies.[22]

DISSOLUTION OF THE OFFICE OF THRIFT SUPERVISION (OTS)

Shuttering the OTS and moving its functions to the OCC, FDIC, CFPB, and Federal Reserve Board of Governors strengthened the regulatory system by removing an agency that had failed to adequately supervise some of the nation's largest savings and loans. Some of the companies—like AIG—that were supervised by the OTS had diversified structures with only a relatively small share of assets in their thrift subsidiaries. Others, like Washington Mutual, were primarily thrifts and clearly within the authority of the agency.

Initially created in 1989 to replace the Federal Home Loan Bank Board in the wake of the savings and loan crisis, the OTS initially gained a reputation for aggressively shutting down failed thrifts. However, since the OTS was funded by assessments from the institutions it regulated, it had a perceived incentive to take a light touch with those institutions responsible for its budget.[23] Over time, the financial industry also realized that Congress had created an alternative structure for savings and loan holding companies that was less restrictive than the bank holding company structure. A number of institutions elected through "charter-shopping" to become thrift holding companies, which resulted in the OTS acting as the consolidated supervisor for large non-bank firms. By 2007, the OTS oversaw some of the most notorious failed and troubled firms of the crisis era, including AIG, Countrywide, IndyMac, and Washington Mutual. The majority and minority staff report of the U.S. Senate Permanent Subcommittee on Investigations wrote that the failure of Washington Mutual, "stemmed in part from an OTS regulatory culture that viewed its thrifts as 'constituents,' relied on bank management to correct identified problems with minimal regulatory intervention, and expressed reluctance to interfere with even unsound lending and securitization practices."[24]

Where Dodd-Frank Did Not Go Far Enough

FSOC AUTHORITY

The new FSOC has the potential to better focus regulators on identifying and preventing systemic risk. However, Dodd-Frank gave the FSOC too little statutory power. While the FSOC can designate non-bank SIFIs and recommend policy actions to its member agencies, it cannot require those agencies to take policy actions or set standards. This structure reflects the tension inherent in a Council composed of regulators that each has its own independent authority. However, as long as such a fragmented financial regulatory structure exists, it is appropriate to expand the FSOC's ability to coordinate rule-writing and to provide that its recommendations must be implemented by member agencies when a supermajority of the Council agrees that such a reform is needed. While such changes would impinge on the independence of FSOC members at the margins, they also would enhance coordination and cooperation among financial regulatory agencies and ensure that major policy reforms rooted in maintaining financial stability and avoiding systemic risks are implemented in a timely manner.

OFR INDEPENDENCE AND POWERS

Like the FSOC, the OFR can have a positive impact on identifying and preventing systemic risk. The agency can cast a wide net as it attempts to see potential financial stability problems on the horizon. However, the ultimate effectiveness of the OFR has yet to be proven. It is critical that it have the necessary independence and requisite powers to act as necessary to fulfill its mandates as free from political influence as possible.

FEDERAL INSURANCE REGULATION

Dodd-Frank created the FIO as the first federal agency with the responsibility to monitor the insurance industry, coordinate federal efforts to develop federal policy on prudential aspects of international insurance matters, and recommend to the FSOC that it designate an insurer as systemically risky. Two insurance companies, AIG and Prudential, already have been designated by the FSOC as SIFIs, making them subject to regulation by the FRB.[25] Other insurance companies could also be designated as SIFIs. Dodd-Frank did not, however, give the FIO the power to regulate insurance companies, write rules, or grant them a national charter.[26]

Creating the FIO gave the federal government an independent ability to evaluate the condition of the insurance industry. However, the law otherwise creates an odd structure under which most insurers will remain under the jurisdiction of state regulators, but a few systemically important insurers will be regulated concurrently by the states and the Federal Reserve Board. This bifurcated regulatory structure for insurers that are designated for supervision by the FRB creates a potential for conflicting and overlapping federal and state regulation. It also places responsibility on the FRB to regulate companies engaged in the business of insurance, which differs substantially from that of banking. In lieu of this structure, the task force believes Congress should create a federal chartering and regulatory structure that would be mandatory for insurers designated as SIFIs and optional for those insurers that would want to operate from a national platform to serve their customers more efficiently and effectively. The new national charter would be overseen by a federal insurance agency with regulatory and supervisory powers, and expertise in the business of insurance.

Where Dodd-Frank Did Not Act

A more problematic subject in looking back at the financial crisis is where Dodd-Frank chose not to act at all. Whether because of political difficulty, competing priorities, basic policy disagreement, or simple miscalculation, these areas represent future potential dangers that have not been sufficiently addressed by policymakers.

CONSOLIDATION OF FEDERAL BANKING REGULATION

If a criticism of U.S. banking regulation before the crisis was that it was too fragmented, it is especially interesting to note that Dodd-Frank eliminated only one agency—the OTS—while creating three new ones: the CFPB, FSOC, and OFR. While each of these actions individually was defensible, the task force believes that Dodd-Frank missed an opportunity to rationalize and streamline the banking regulatory system to make it simpler, more accountable, and more effective for all stakeholders—and less prone to contribute systemic risk.

IMPROVED QUALITY OF BANK EXAMINATIONS, TRAINING, AND COMMUNICATIONS

One of the consequences of the fragmentation of the U.S. financial regulatory system is overlap and duplication in examination forces. Agencies that conduct similar exams may have a different, and potentially conflicting, examination focus, and they are forced to re-create operational and human resources functions. Expertise and specialized knowledge at one agency may not be shared with others that could make use of it. Such inefficiencies are both wasteful and confusing for stakeholders in the bank examination process, and a new approach is warranted.

Part of that new approach should include improving the quality of communications and interactions with state banking regulators, which are coming under increased budgetary pressures with respect to hiring and retention. Better sharing of information and leveraging of key expertise and knowledge for the benefit of state regulators will enhance the entire financial regulatory system.

CONSOLIDATION OF CAPITAL MARKETS REGULATION

The separation of capital markets regulation in the United States into separate agencies—the CFTC and SEC—has been less justifiable with each passing year. The increasingly blurred lines between futures and securities trading have fueled turf battles that have characterized the relationship between the two agencies over the years. A different turf battle, this one among the agriculture, financial services, and banking committees in Congress, has left numerous proposals to merge the two agencies without enough political support to pass. The potential gains from creating a single capital markets regulator in a modern economy warrant reconsideration of the merger of the two agencies. The United States is the only Organisation for Economic Co-operation and Development (OECD) nation with a regulatory system that features this particular historical aberration.

INDEPENDENT AND APPROPRIATE FUNDING

U.S. financial regulatory agencies were created as independent entities to shield them from political pressures and enable them to make decisions with the long view in mind. An agency cannot be truly independent, however, while remaining dependent on Congress for its funding. While the federal banking agencies have an independent funding source, the CFTC and SEC still rely on congressional appropriations and have been chronically underfunded.[27]

In addition to ensuring that all agencies are on equal footing with independent funding sources, funding should be levied appropriately in order to prevent charter-shopping. While the OTS, noted for attracting regulated entities with its light-touch regulation, was eliminated by Dodd-Frank, the potential for future charter-shopping should be addressed when designing optimal funding regimes.

Recommendations

This report presents a series of practical recommendations that deserve the attention and consideration of policymakers, financial regulators, and the public at large. In some cases, these recommendations can be implemented without legislative action, while other recommendations provide actions for Congress to consider. As a whole, these recommendations would substantially improve the performance of the U.S. financial regulatory system, enabling it to support greater financial stability and a dynamic, growing economy.

Recommendation #1: Improve the Quality of Prudential Supervision

Banks and thrifts, and their holding companies, are subject to examination by multiple federal and state financial regulators.[28] Supervision conducted at the level of individual institutions is the foundational safeguard provided by the financial regulatory system. Prudential supervision ensures that financial institutions are sufficiently capitalized, are not engaging in activities that are too risky, are liquid enough to meet their obligations, and are otherwise safe and sound. The Basel Committee on Banking Supervision wrote that "the key objective of prudential supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors."[29] And, as FDIC Vice Chairman Thomas Hoenig has said, "The best way to judge a firm's risk profile is through the audit and examination process."[30]

The current examination system, however, is often fragmented, with overlapping and duplicative responsibilities. A banking group that consists of a parent holding company, a subsidiary national bank, and subsidiary broker dealer would be subject to examinations by the Federal Reserve Board (for the holding company), the OCC (for the national bank), the FDIC (as the insurer of the national bank), the CFPB (for the national bank),[31] and the SEC (for the broker dealer). If the holding company also owned a state-chartered bank, then that bank would be subject to examination by the state and either the FDIC or a Federal Reserve Bank, depending on whether the state bank is a member of the Federal Reserve System or not. Each of these agencies has a specific mission and focus, leading examiners for the agencies to pursue different objectives. There is an opportunity for greater coordination and cooperation among the federal prudential banking agencies since they share a common safety-and-soundness goal and have limited resources.

While these agencies do not require exactly the same personnel and resources—the OCC's examiners, for example, need to know more about the intricacies of large bank commercial activities and lending and less about community banking than do the FDIC's—there is considerable overlap. Some coordination occurs among these agencies today, but there is also duplication of expertise, human resources, operations, planning, management, and other functions. In addition, differing budget cycles within the agencies can complicate the ability of the agencies to allocate examination personnel in a complementary manner.

Moreover, more could be done to improve the quality of supervision. Increased compensation and training opportunities for examiners, along with a career path that is better defined by universities and regulators, for example, can help ensure that the overall quality of prudential examination is improved broadly and over the long term.

The task force therefore makes four main recommendations to improve the quality of prudential supervision:

Recommendation 1(a): Establish a Pilot Program for an Enhanced, Consolidated Examination Force for Insured Depository Institutions and Depository Institution Holding Companies

The task force recommends the creation of a pilot program for a consolidated examination force for the institutions subject to supervision by the three federal prudential banking agencies (the FRB, FDIC, and OCC). Such a program would improve and enhance the efficiency and quality of the examination and supervision of insured depository institutions and their holding companies through better coordination and training with improved efficiencies. **To test the feasibility of a consolidated examination force, and to identify and address the variety of operational issues associated with this concept, the task force recommends that the pilot program be overseen by the FFIEC.**

It is suboptimal for the various prudential banking agencies to share a similar safety-and-soundness function, yet operate independently. The task force believes the efficiency and quality of examination and supervision of insured depository institutions and their holding companies could be improved through the creation of a consolidated examination force for the institutions subject to supervision by the three federal banking agencies (the FRB, FDIC, and OCC). This approach contemplates an integration of examination personnel and related human resources functions under the direction of a "supervisory" committee within the FFIEC that would provide a coordinated examination focus for examiners. It would not, at this stage, impact the existing rule-writing or enforcement responsibilities of the respective agencies. However, the federal banking agencies would be able to draw from a common set of examiners with consistent training and uniform, dedicated expertise.

This approach would enable examiner teams to take advantage of interchangeable elements offered by each agency. At the same time, it would permit the development of specialized teams. For example, examiners could specialize in banks of certain sizes and complexities, geographic regions, or predominant lines of business (e.g., agricultural loans, small-business lending, commercial real estate, and derivatives). This would provide a greater opportunity, for example, for an examiner who typically examines small, state-chartered agricultural banks in Minnesota to do the same for small, nationally chartered banks in Nebraska or Kansas.

The overall quality of bank examinations also would be improved by a series of other actions, described below, that are designed to provide a clearer, more rewarding career path for examiners.

Upon the eventual consolidation of prudential bank regulatory agencies, a fully consolidated bank examination force promises several advantages over the current, more fragmented system:

- Uniform standards for training and management of examiners and supervisors should lead to more consistent and translatable examination results and expectations, as well as streamlining the process for both regulators and financial institutions.
- Consolidation should improve communication among supervisory teams since examiners would be trained under a common framework and be overseen by a unified committee of supervisors drawn from the three agencies. Since financial stability can be threatened by a lack of communication among agencies, the advantages of this structure should be substantial.
- Integrating key support operations—such as hiring, training, compensation, and promotions—for examiners should make the management of the examination force more efficient and less costly compared with sustaining the same functions at multiple agencies.
- Consolidated budgeting for examiners and examinations would enable the agencies to better coordinate and apply examiner teams to particular lines of business or institutions.
- Regulators could better leverage their specialists, whose expertise would be usable across a wider set of institutions. This would improve the overall quality of examination teams, because those teams would be able to draw on a wider variety of experiences and best practices.
- Human capital among examination teams would be developed by providing greater opportunities for career advancement, consistent and higher compensation standards, and a better-defined and supported career path.
- As the Paulson Blueprint stated, "a more efficient, and thus competitive, system for federal banking supervision of state chartered-banks should effectively focus examination resources and avoid duplication."[32] The quality of state regulation would be significantly boosted by allowing individual states to leverage federal examination teams to assist in state examinations. State agencies often cannot afford to employ

multiple specialists or do not have the overall level of resources available to the federal agencies. To the extent that the federal examiner training and procedures incorporate individual state supervision objectives, state bank supervisors may elect to put greater reliance on accepting a federal examination in lieu of a separate state examination.[33] Federal regulators would also benefit from better information-sharing with states through this process.

These proposals exist in harmony with the dual banking system. The task force believes that the existence of both federally chartered and state-chartered banks provides great benefits, offering more choices for consumers and allowing for greater policy innovation by individual states. The consolidated examination force envisioned here will provide more and better resources to both state and federal jurisdictions, thereby improving the quality of supervision across the board.

INTERAGENCY MAKEUP

While the task force is proposing a consolidation of the safety-and-soundness examination process, the plan does not contemplate the incorporation of CFPB, CFTC, or SEC examiners in this consolidated examination force.[34]

The CFPB employs supervisors as well, but approaches examinations with a focus on consumer protection and activities rather than on safety and soundness and individual institutions. The CFPB was established by Dodd-Frank as an independent, standalone agency to allow it to pursue supervision according to a different set of goals. Therefore, while the task force recommends that the CFPB's Division of Supervision, Fair Lending, and Enforcement work closely with the consolidated examination force, the CFPB's examiners should not be included in the force.

The CFTC and SEC do not conduct examinations for institutional safety and soundness. Therefore, the two capital markets regulators also would not be included in this consolidated examiner force. They should, however, maintain and expand a dialogue with the prudential banking agencies on matters of mutual interest to the extent permitted under laws regarding the sharing of confidential bank supervisory information.

DEVELOPMENT AND COORDINATION OF THE PILOT PROGRAM

The FFIEC was established in 1979 to better coordinate principles, standards, and report forms among the financial banking agencies. The FFIEC's membership now includes the CFPB, FDIC, FRB, National Credit Union Administration (NCUA), OCC, and a state banking regulator selected by the Conference of State Bank Supervisors (CSBS). The chairmanship of the Council rotates every two years among its members. The FFIEC already conducts training for multiple agencies, with a focus on continuing education.[35] The FFIEC is designed to foster cooperation among its member agencies. Although not statutorily powerful, it has achieved some success in areas such as standardizing examination procedures and forms,[36] issuing joint policy statements,[37] and creating its IT Examination HandBook.[38]

For the purposes of the pilot program, the FFIEC should establish a Committee on Bank Supervision, the members of which would be the heads of supervision for the three prudential banking agencies and the FFIEC's state banking regulator. The associate director of the CFPB's Division of Supervision, Enforcement, and Fair Lending would be included on the committee as a non-voting member, since the CFPB's examination staff would not participate in the pilot, but the Bureau's input would nevertheless be valuable. This Committee on Bank Supervision would be responsible both for building and executing the pilot program, and for laying the groundwork for full consolidation following the creation of the consolidated prudential regulator described in Recommendation 2. Specifically, the Committee should:

- Establish consistent supervisory priorities, protocols, and procedures that examination teams should learn and use;
- Develop one- and two-year plans for the process leading to completion of the examination force within a consolidated Prudential Regulatory Authority;
- Update or create as necessary any memoranda of understanding between bank regulators and the SEC, CFTC, and CFPB, on how each can and will leverage its expertise and knowledge to produce better bank examinations;
- Write and execute a memorandum of understanding between each prudential regulator and the OFR that would designate the OFR as the lead coordinating agency in data-collection efforts and would delineate the authorities and responsibilities of each agency in that process; and
- Work with state banking supervisory agencies to create memoranda of understanding on the interaction and responsibilities of state and federal regulators regarding banks for which there is mutual interest.

Concurrent with these steps, the FFIEC should work with the CSBS to define an initial scenario for a trial of a limited consolidated examination team. The pilot should:

- Be geographically limited, likely to one or two state(s);
- Include examinations of banks of different sizes, levels of complexity, and charters (i.e., at least one bank each that has a national charter, is a state-chartered member of the Federal Reserve System, and is a state-chartered non-member of the Federal Reserve system);
- Include examiners with jurisdiction from each of the agencies involved in the pilot, where each of the agencies would have overlapping jurisdiction with at least one other agency;
- Assign leadership of each examination team to a representative from the primary regulator—including both federal and state agencies—of the institution the team will examine;
- Ensure that each examination produces a single, combined report that is available to all agencies that participate in a particular exam;

- Involve a range of specialized experts from each agency;
- Be supported by funding and personnel resources contributed by participating agencies in proportion to the share of total assets being examined in the pilot program for which each agency is the primary regulator;
- Require post-mortem analysis after each examination to identify strengths and weaknesses in the examination process, ways to improve future examinations, and whether having direct access to the consolidated examiner pool and reports is beneficial to the agencies without primary supervisory authority over a given bank; and
- Conclude within a set time period (e.g., after two years).

The FFIEC's mission to better coordinate the examination process for financial institutions is a good fit for this task. And, setting up a program among multiple agencies and jurisdictions would be quicker and easier than creating a new body for the same purpose since the FFIEC includes each of the agencies that would participate in the pilot program, including a member that represents state regulators. Creating a consolidated examination force pilot program, however, will require the members of the Council to allow the FFIEC to properly coordinate the program.

At the conclusion of the pilot program, the FFIEC should adjust its proposed policies as warranted by its experiences.

Recommendation 1(b): Transition to Consolidated Examination Force

By the conclusion of the pilot, legislation will be necessary to formally consolidate the targeted agencies. For the transition, the task force recommends that the FFIEC be empowered to coordinate implementation of the consolidation through the Committee on Bank Supervision.

During the transition, the FFIEC would be responsible for setting employee policies and standards, conducting training for the group of examiners, and coordinating other common human resources and operational functions. Each of the three prudential bank regulatory agencies would have full and equal access to final examination reports produced by the consolidated force.

Since the overall quality of banking supervision in the United States relies heavily on how well state supervisory agencies do their work, the task force recommends that state agencies be allowed to augment their capabilities by requesting the use of examination teams and specialists from the consolidated examination force. State agencies would also have access to data and examination reports where appropriate. In exchange, those state agencies would be expected to contribute resources to the examination pool that is proportional to the benefits they derive from it. The terms of such arrangements would be negotiated through memoranda of understanding between individual states and the FFIEC, and could include the contribution of funding, state examiner time, or other required resources.

As part of its coordinating role, the FFIEC should report on its efforts to improve the quality of bank supervision through these recommendations in its annual report to Congress. Similarly, the Congress should conduct regular oversight hearings to assess the progress made with this and other recommendations in this report.

Recommendation 1(c): Improve Examiner Compensation

The task force proposes that the Committee on Bank Supervision set market-influenced compensation goals for bank examiners.

As private-sector salaries in financial services have increased over the past few decades, it has become increasingly difficult for financial regulators to attract and retain the best and brightest. High-quality financial regulation requires a regulatory corps able to adapt its oversight commensurate with, and as rapidly as, the pace of innovation and other changes in industry practices. Although steps have been taken over the years to increase compensation for examiners, it has not increased at the same rate as those in the private sector. The subject should be regularly revisited and assessed using an objective, fact-based process.

A review of White House Office of Personnel Management data shows the following ranges, means, and medians for examination personnel at seven federal financial regulatory agencies:[39]

	CFTC	CFPB	FDIC	FHFA	NCUA	OCC	SEC
High Salary	$226,000	$245,000	$246,000	$255,000	$247,000	$260,000	$201,000
Low Salary	$63,000	$40,000	$50,000	$84,000	$47,000	$49,000	$83,000
Mean	$122,000	$109,000	$113,000	$151,000	$100,000	$122,000	$140,000
Median	$122,000	$103,000	$114,000	$147,000	$96,000	$120,000	$147,000

Personnel at these independent agencies are paid at a higher rate than employees on the federal government's General Schedule (GS) pay scale. The Financial Institutions Reform, Recovery and Enhancement Act of 1989 (FIRREA), gave the above regulators minus the CFPB the authority to set their own compensation schedules to keep them more competitive with private-sector salaries.[40] The CFPB was added to the list upon the passage of Dodd-Frank.

Similar individualized, anonymous data on examiner salaries is unavailable for the Federal Reserve Board and Federal Reserve Banks. However, 11 of the Reserve Banks provided BPC with salary ranges for their examination personnel. A comparison of their salary practices shows the following:[41]

Federal Reserve Bank	Low Salary	High Salary
Atlanta	$45,000	$171,000
Boston	$56,000	$203,000
Chicago	$38,000	$193,000
Cleveland	$37,000	$221,000
Dallas	$48,000	$158,000
Kansas City	$38,000	$144,000
Minneapolis	$43,000	$163,000
New York	$58,000	$371,750
Philadelphia	$40,000	$137,000
Saint Louis	$37,000	$159,000
San Francisco	$49,000	$324,000

Federal government salaries likely will never equal that of top private-sector jobs; nor should they. There are inherent differences between public-sector and private-sector employment. Private companies, particularly on Wall Street, tend to offer higher salaries for competitive purposes, but they also can subject employees to less job security and higher stress levels. Federal government jobs tend to offer substantive work, greater relative security, work-life balance, and a sense of public service at lower salaries. Nonetheless, compensation levels for federal examiners should be at a level sufficient to attract and retain high-quality individuals who are looking for long-term public-service careers.

The Committee on Bank Supervision should set compensation goals with these criteria in mind for each of the consolidated examination force agencies and review them annually to adjust rates accordingly.

Recommendation 1(d): Launch New Degree and Training Programs

The task force recommends that the Committee of Bank Supervision work with multiple colleges and universities to set up specialized undergraduate and master's degree programs for bank examiners.

In addition to training better supervisors, specialized undergraduate and graduate programs for examiners would raise the profile of examination as a career and allow degree seekers to be better prepared to hit the ground running when they join agencies.

Thousands of people in the United States are employed as bank examiners, an increasingly complex profession that requires technical proficiency and specialized skills and knowledge. The high demand for quality personnel is expected to grow in the coming years, because many current examiners are approaching retirement[42] and because Dodd-Frank and other financial regulatory reforms require greater supervisory efforts.[43]

The Committee on Bank Supervision will be best positioned to understand the needs of federal and state regulators and should develop a suggested curriculum for such a degree program with interested higher-education institutions. The FFIEC should also create processes to help place degree candidates and recipients with the FFIEC's member agencies for internships and career-path jobs. The FFIEC should set numerical goals for:

- The number of colleges and universities offering undergraduate and master's degrees in bank examination;
- The number of slots offered by federal financial regulatory agencies for bank examination degree-holders;[44] and
- Dates by which such goals should be achieved and how to accomplish them.

The task force's recommendation would complement current in-house training efforts by FFIEC member agencies, rather than replace them. While ongoing training should be the part of any regulatory agency, focused university training will ensure that people who decide to pursue bank examination as a career are better prepared for agency positions from day one.

Recommendation #2: Create a New Structure for Prudential Regulation

The task force recommends a new structure for prudential regulation that will result in each bank, bank holding company, and federally chartered insurance company having a single prudential regulator.

The current U.S. financial regulatory system is the result more of accretion than design. The system evolved over time, largely in response to individual financial crises, and with insufficient regard to questions of coordination and cooperation. As a result, the United States has a fragmented financial regulatory structure, which contributed to the financial crisis in part because individual regulators focused attention on their respective missions and no single regulator was charged with monitoring the financial system as a whole. The FSOC and OFR are designed to address part of this problem. Yet, additional steps should be taken to provide for greater coordination and cooperation among regulators. The recommended consolidated examination force is an interim step toward a fuller reorganization of the U.S. banking regulatory system that will be more responsive to current market conditions. A structure where a single banking agency is responsible for prudential regulation will be more accountable to all stakeholders, including the public, regulators, and industry.

The task force proposes a new model under which:

- All individual banks and thrifts and their holding companies would be supervised and regulated by a new Prudential Regulatory Authority (PRA). The PRA's jurisdiction would include all banks—including systemically important banks (SIBs)—and thrifts, and their holding companies. The PRA would be the primary micro-prudential regulator and rulemaking body for individual financial institutions and holding companies. This would complement the Federal Reserve's repurposed role of focusing on more systemic, macro-prudential threats to the U.S. financial system.

- The FRB would retain its important role as a financial stability and macro-prudential regulator for systemic risk, and have the power to recommend enhanced prudential standards for financial institutions as part of its macro-prudential role. Working with an enhanced FSOC and OFR, the FRB would focus its efforts on monitoring and identifying market trends, activities, and conditions that need greater systemic attention by a macro-prudential regulator able to look across individual institutions. The Federal Reserve would also have full and immediate access to all PRA exam reports and data for use in achieving its financial stability and other goals. The Federal Reserve would be the unified financial stability regulator for systemically important non-bank non-insurer financial institutions, including retaining its role as the primary supervisor for FMUs. The agency would transfer its remaining supervisory authority for banks and thrifts, and their holding companies, to the PRA.

- The FDIC would focus on its current roles as depository insurer and resolution authority and transfer its primary supervisory authority over state non-member banks to the PRA. The FDIC would have backup supervisory authority over all institutions that it insures and full and immediate access to all exam reports and data.

- A single federal insurance regulator would oversee and supervise a modern national insurance charter that would be mandatory for all insurance companies designated by the FSOC as SIFIs, but be optional for all other companies that wanted to meet the needs of their customers from a single national charter and one set of regulations.

The task force believes these changes would result in clearer lines of authority and greater transparency; greater focus, efficiency, and accountability; cost savings; and improved quality of financial supervision. Such changes would also lead to better regulation and regulatory outcomes for all stakeholders and for the U.S. economy.

Recommendation 2(a): Create a New Prudential Regulatory Authority

The task force recommends establishing a new Prudential Regulatory Authority (PRA), which would combine the OCC with the existing primary bank supervisory authority of the Federal Reserve and FDIC.

The idea that the U.S. financial regulatory system is too fragmented is not a new one. The FDIC once compiled a list of 24 major proposals for regulatory restructuring that had been made since the 1930s, none of which were implemented.[45] Inertia and turf battles between agencies and congressional committees are among the dynamics that make significant changes to the regulatory structure difficult.

The financial crisis temporarily changed those dynamics and made some optimistic that a more streamlined regulatory structure could be achieved in what later became the Dodd-Frank Act. While Dodd-Frank eliminated one agency, the OTS, it created three new ones: the CFPB, FSOC, and OFR. Despite eliminating the OTS, Dodd-Frank kept responsibility for prudential regulation in the hands of multiple agencies.

Greater consolidation of prudential regulation would benefit the U.S. regulatory structure in a number of ways. First, it would reduce the likelihood of gaps that inevitably form over time as the result of market dynamics and innovation, changes to statutes, interagency conflicts, and poor communication. A single prudential regulator would not be immune from these problems, but it should be better able to limit them through easier communication and a more rapid response in a crisis.

A second set of advantages of a single prudential regulator are similar to those already outlined in the task force's recommendation on a consolidated examination force. The efficiencies and other benefits of consolidating training, human resources, and other operational functions could be fully realized by joining them into a unified structure.

Third, a single prudential regulator would limit future opportunities for regulatory arbitrage. Dodd-Frank eliminated the OTS in part because some firms elected for a thrift charter in order to engage in a wider range of activities and to fall under the jurisdiction of an agency that did not have sufficient resources to effectively supervise all of its institutions. Subjecting all FDIC-insured banks and their holding companies to the same rules and requirements makes it harder to game the system.

Fourth, having a single prudential regulator makes it easier to assign responsibility for the successes and failures of supervision. This is particularly important for policymakers considering changes and to the public in demanding high-quality regulation.

One criticism of consolidating supervision is that it can lead to groupthink and reduced innovation that can be mitigated by competition between multiple agencies. Such concerns are a danger at any organization, each of which should work to encourage new ideas, diversity, and appropriate management and processes to account for them. It is not clear, however, that a fragmented structure does not create the same dangers with fewer benefits. Multiple U.S. regulatory agencies, for example, were of a similar mind that risky pre-crisis practices in the mortgage finance industry were not likely to lead to a financial crisis. The task force believes the better solution is to set clear lines of responsibility for those agencies within the regulatory structure and to ensure an appropriate balance of authority and resources for agencies responsible for macro- and micro-prudential issues.

The PRA would be responsible for safety-and-soundness regulation of commercial banks and thrifts, and their holding companies. Consolidated supervision and regulation of holding companies and their bank or thrift subsidiaries is particularly appropriate for those banking organizations in which the bank is the principal operating entity and the holding company is merely a shell. Consolidated supervision of holding companies and their bank or thrift subsidiaries also is appropriate for other larger organizations since it would eliminate the potential for conflict or overlap in the regulation and supervision of the parent company and a subsidiary bank or thrift.

Federal Reserve and FDIC supervisory responsibilities for member and non-member state banks would be shifted to a state banking division within the PRA to minimize disruption. A small bank division inside the PRA would focus on banks and thrifts with assets less than $10 billion.

The PRA would be governed by an independent five-person board, the members of which would be subject to staggered five-year terms and Senate confirmation, and no more than three of whom could belong to a single political party. Board structures are advantageous because, among other things, they better allow for differing points of view, are more stable, and have a larger capacity than single-director agencies. However, there are real disadvantages to the board structure, including the potential for more gridlock. To avoid that outcome, the task force recommends a structure that includes a relatively strong chairman. First, the president would be able to appoint as chairman any board member who has been confirmed to that post. This is similar to the current SEC model. In addition, the chairman would have the ability to cast the deciding vote in a case where the board vote results in a tie. Finally, the staff of the PRA would report to the chairman. Taken together, these provisions would reduce gridlock and help make the PRA a more effective agency.

The PRA would fund itself through an equitable assessment regime similar to that of the OCC, which bases assessments on the total assets of supervised institutions.[46] Unifying all bank supervision in a single agency will limit the problem of charter-shopping that can lead regulators to relax oversight to prevent institutions they supervise from switching charters to fall within the jurisdiction of another agency.

The new structure for prudential supervision recommended in this report works in harmony with the dual banking system. Today, state banks do not pay fees to the FDIC or Federal Reserve for their federal examinations of state-chartered banks. That state of affairs should continue after federal supervisory authority for state banks transfers to the PRA. The Federal Reserve and FDIC will have full and immediate access to the examination output of the PRA, but will no longer need to support the supervisory staff that they do today. Therefore, it makes sense for the FDIC and Federal Reserve to fund the PRA's cost of supervising state-chartered banks currently supervised by those two agencies.

Finally, the PRA would inherit the OCC's current seat on the Basel Committee on Banking Supervision, while the FDIC and FRB would retain their membership on the same body.

Recommendation 2(b): Focus the Federal Reserve on Systemic Risk and Macro-Prudential Supervision

The task force recommends focusing and enhancing the Federal Reserve's responsibility for financial stability and systemic risk through a more clearly defined role for macro-prudential regulation and supervision.

Having transferred its primary supervisory authority of bank and thrift holding companies to the PRA and of SIFI insurance companies to a new federal insurance regulator, the task force envisions the Federal Reserve increasing its focus as a macro-prudential regulator.[47] In this capacity, the Federal Reserve monitors activities, trends, and emerging issues in the financial system as a whole, adjusting its management of the economy based on the results of more focused macro-prudential surveillance and standard-setting. A memorandum of understanding should be reached with the PRA, CFPB, and OFR so that the Federal Reserve has full and immediate access to relevant data to support its systemic oversight and monitoring of the economy. In addition, the FRB would retain supervisory powers over financial market utilities that conduct payment, clearing, or settlement activities; its authority to serve as a source of liquidity in extraordinary times; and its conduct of monetary policy.

Although primary supervisory authority would be transferred from the Federal Reserve, the agency would retain backup supervisory authority over systemically important banks and insurance companies, and their holding companies. When the FRB deems it necessary for financial stability purposes, the agency would have the authority to examine an institution by sending in a supervisory team of its own. As noted above, the Federal Reserve also would have the ability to recommend heightened prudential standards for financial institutions as part of its own heightened macro-prudential role.

Recommendation 2(c): Focus the FDIC as insurer and resolution authority

The task force recommends that the FDIC be more focused on its role as insurer and resolution agency, and not on its role as a primary, day-to-day supervisor of state-chartered, non-member banks.

The FDIC serves a critical role as deposit insurer. In Dodd-Frank, the agency was given a significantly larger role in the recovery and resolution of large bank and non-bank institutions. BPC's Failure Resolution Task Force largely commended the FDIC in its approach to handling their new resolution authority under Title II of Dodd-Frank.[48] Transferring primary bank supervisory authority to the PRA will better focus the FDIC on these two important functions, while empowering the agency with backup supervisory authority will ensure it has access to information about the health of the institutions it insures through the Deposit Insurance Fund (DIF).

To properly perform these functions, the FDIC must have a good understanding of the condition of insured institutions. However, it does not follow that the agency must be the primary regulator and supervisor of a subset of state-chartered banks to access such information. Indeed, the FDIC does not now have primary authority over banks that control most of the deposits it insures through the DIF. The FDIC and PRA should develop a memorandum of understanding, similar to that between the PRA and Federal Reserve, making certain the FDIC has full and immediate access to all PRA data required to fulfill its two primary roles.

In addition, the FDIC should retain backup supervisory authority over all the institutions that have depositors that are covered by the DIF. In practice, this means that the FDIC would be able to conduct an on-site review of an institution that it believes is at risk of failure—necessitating an FDIC resolution proceeding—or of triggering the FDIC's use of the DIF to keep the institution's depositors whole. The FDIC's examination priorities in this area, however, should be focused on troubled banks that do or might present a danger of losses to the DIF.

Recommendation 2(d): Authorize New Federal Insurance Charter and Regulator

The task force recommends the creation of a new federal insurance charter and Federal Insurance Regulator (FIR), which would be the primary insurance regulator for any insurance company designated as systemically important by the FSOC or any company that opts for a national insurance charter to better serve its customers.

Dodd-Frank created the FIO as the first federal agency with the responsibility to monitor the insurance industry, but did not give it the power to regulate insurance companies or write rules.[49] Two insurance companies, AIG and Prudential, already have been designated by the FSOC as SIFIs. At least one other insurance company, MetLife, is being considered for designation, and others could be in the future.

Creation of the FIO was an appropriate step to give the federal government a better insight into the insurance industry. However, the designation of insurers for supervision by the FRB, whether as a result of being designated as SIFIs or structured as thrift holding companies, creates a system in which some insurers will be subject to supervision by both states and the FRB. This creates a potential for conflict and competitive inequality, especially because the focus and policies of state insurance regulators and the FRB differ in many respects.

And, it creates a situation where SIFI and other insurance companies face the extra costs of federal regulation[50] without the benefits that normally go with it, such as being subject to consolidated regulation by a single federal agency rather than multiple state regulators.

The FIO is a first step toward a more rationalized national insurance regime, something that almost all other developed economies have. The presence of large firms that have been designated as systemically important begs the question of why the United States does not also have a national charter and federal regulator with rulemaking and enforcement authority and a detailed knowledge of the insurance industry. This is especially true for those insurance companies designated by the FSOC as systemically important, but also for others that want to opt-in based on business strategy, customer services, and other considerations. A 2013 report by the Financial Stability Board (FSB) noted that the U.S. system is fragmented domestically, which affects America's ability to speak with a single voice in international insurance forums:

> The architecture for insurance supervision in the US, characterized by the multiplicity of state regulations, the absence of federal regulatory powers to promote uniformity and the limited rights to pre-empt state law, constrains the ability of the US to ensure regulatory uniformity in the insurance sector. While the FIO represents the US on international insurance matters and negotiates covered agreements, only the states have the authority (but are under no legal obligation) to implement laws that are consistent with those agreements and international standards.[51]

In response, the FSB recommends that:

> US authorities should promote greater regulatory uniformity in the insurance sector, including by conferring additional powers and resources at the federal level where necessary. The FIO should enhance its monitoring of the sector through increased use of non-public information, and be further strengthened to be able to take action to address issues and gaps identified.[52]

Systemically important insurance companies should be subject to federal regulation, but such regulation should not apply bank-centric rules to insurance companies, a point acknowledged by the Federal Reserve Board when it promulgated its final rule on heightened prudential standards for large banks under Sec. 165 of Dodd-Frank on February 18, 2014.[53] Insurance regulation needs to take into account the significant differences in the business models, balance sheets, revenue streams, and risk profiles of insurance companies from banks and other financial institutions. For example, the term-structure of liabilities for an insurance company is very different from that of a bank, which would argue for a fundamentally different approach to determining appropriate levels of capital and liquidity requirements for each.[54]

This is not to say that insurance companies cannot generate systemic risk. However, an FIO 2013 report noted that:

> Financial stability concerns arise more often when traditional insurers engage in non-traditional activities, such as derivatives trading, securities lending, or other shadow banking activities, or when they offer products that have features that make them susceptible to runs.[55]

Macro-prudential oversight of the insurance industry can help to identify systemic risk that may be created within that sector, such as those that emanated from AIG prior to the financial crisis.

The FIO report further "recognized uniformity as a central concern regarding the current system of insurance regulation in the United States. … The impact of this lack of uniformity is felt acutely in both prudential matters and in certain areas of marketplace oversight. To address the inefficiencies and lack of uniformity in the state regulatory system, federal involvement will be necessary."[56]

The task force agrees in general with the Paulson Blueprint and the proposed National Insurance Act of 2007 that an optional national insurance charter should be established. Any insurance company that opted into the national charter would be regulated by the FIR, which would replace the FIO, instead of by one or more state insurance regulators. The FIR would be given authority similar to other financial regulatory agencies to supervise and to write and enforce rules and regulations on its chartered entities. Insurance companies designated by the FSOC as SIFIs would be required to adopt the national insurance charter and would be supervised and regulated by the FIR. Implementation of this recommendation will put the U.S. financial regulatory system on an equal footing with most other G20 countries and allow for more focused regulation of insurance.

Recommendation 2(e): Phase Out the Thrift Charter

The task force recommends the phase-out of the thrift charter after three years in favor of a modern banking license designed to meet the dynamic needs of all consumers of bank products and services.

Both commercial banks and non-banks originate mortgages, so the need for a separate legal charter has been overtaken by marketplace developments. In addition, Dodd-Frank contained provisions that removed several of the remaining advantages that thrifts enjoyed compared with banks. These changes include subjecting thrift holding companies to formal capital requirements, giving banks parity with thrifts in the ease of establishing branches, and making state consumer financial laws apply to subsidiaries of federal thrifts.[57] Dodd-Frank also closed the OTS, the agency that had provided consolidated regulation to thrift holding companies and their subsidiaries, and divided the OTS's responsibilities among the FRB, OCC, FDIC, and CFPB.

However, some gaps remain between the federal thrift and bank charters. Dodd-Frank, for example, still permits thrift holding companies to engage in some activities that are impermissible for banks, such as real estate development and management. Moreover, Dodd-Frank left in place portfolio and lending limits of federal thrifts, a disadvantage to the thrift charter—and one that could pose risks in restricting the ability of thrifts to diversify their holdings.[58]

The federal thrift charter was created in 1933 to increase the availability of residential mortgage liquidity. Changes in the marketplace and in statute over time have eroded the logic for retaining a separate federal thrift charter, and the advantages to financial institutions in opting for a thrift charter. Both the Paulson Blueprint and Geithner white paper recommended the eventual elimination of the charter and, in the interests of simplifying the U.S. regulatory structure, the task force agrees. Therefore, the task force proposes that the thrift charter expire three years after the PRA begins operation, to be replaced by a new, single federal banking charter with broad consumer and commercial banking powers that is fully empowered to meet the needs of all potential bank customers.

Recommendation 2(f): Allow the chair of the Federal Reserve Board to fill the position of vice chairman for supervision absent a presidential nominee

The task force recommends that the chairman of the Federal Reserve Board be allowed to fill vacancies for the position of vice chairman for supervision, absent a nomination by the president, with an acting vice chairman.

Earlier, the task force recommended that the Federal Reserve be focused on macro-prudential supervision. The position of vice chairman for supervision at the FRB that was created in Dodd-Frank should accordingly be updated to reflect this change. Therefore, the vice chairman for supervision should be given direct responsibility for implementing and overseeing the FRB's new macro-prudential mandate, including its backup supervisory role.

Further, it is incumbent upon the president to nominate someone to fill the role of vice chairman for supervision at the FRB. The position, created on July 21, 2010, has yet to see a single nominee nearly four years later. There is no persuasive reason for this delay in giving the FRB the focus and leadership on systemic risk it needs, as well as the necessary financial stability supervision to fulfill its new oversight role for all of finance, not just the banking system.

Filling this position is important for the quality of supervision in general, and particularly so to implement the task force's plan to improve upon the current system. Therefore, the task force recommends that Congress give the FRB's chairman the authority to name an acting vice chairman from the roster of existing Senate-confirmed FRB governors at any time the position of vice chairman for supervision is vacant and no one has been nominated by the president to fill the position. A different person subsequently nominated by the president and confirmed by the Senate would replace the acting vice chairman.

Recommendation #3: Better Address Systemic Threats by Empowering the FSOC and OFR

The powers of the FSOC need to be clarified to ensure greater accountability and the Council's ability to fulfill its statutory mandate under Dodd-Frank.

The creation of the FSOC and its research arm, the OFR, are potentially positive features of the Dodd-Frank Act. Prior to the crisis, U.S. regulators were too often either unaware of systemic threats to the financial system, or unable to build consensus for corrective action around known risks.

The reasons for this were more complex than negligence. For example, the doctrine of prompt corrective action (PCA) was at the heart of the Federal Deposit Insurance Corporation Improvement Act of 1991, key legislation that was passed to attempt to correct the mistakes that led to the savings and loan crisis. PCA mandated progressively higher penalties on banks as their capital ratios got worse in an attempt to quickly stop institutional deterioration. The use of PCA was an important tool for regulators, who generally believed that bank safety and soundness degraded over time as the result of deteriorating asset quality. Regulators realized during the crisis of 2007 and 2008 that PCA was insufficient because asset quality can worsen rapidly and unexpectedly. More, better, and timelier information on the health of financial institutions proved to be necessary. Accordingly, the FSOC and OFR were given macro-prudential roles in the U.S. regulatory system. However, neither entity has yet to fulfill its promise, in part because of limitations Dodd-Frank made on their respective authorities.

The FSOC's ten voting and five non-voting members are a broad representation of bank and non-bank regulatory entities that includes agencies that do not regulate any institutions designated as systemically important, or requiring enhanced supervision for systemic purposes. The FSOC has been meeting since October 2010 and has designated three non-bank institutions—first AIG and GE Capital,[59] and then Prudential[60]—as SIFIs and recommended that the SEC implement additional regulations on money market mutual funds.[61] Despite these actions, the Council's effectiveness in achieving its mandate has so far been largely untested.

The FSOC is charged with serving as an information-sharing and regulatory policy-coordinating body for its members agencies. The FSOC has generally held meetings monthly instead of quarterly as statutorily required, showing that the body appears to have become a useful forum for agencies to discuss issues of mutual concern. However, it is not evident that this dialogue is producing greater coordination or cooperation among member agencies. In fact, there is at least anecdotal evidence of significant competition among regulators in this post-Dodd-Frank period.[62] The ability of the FSOC to fill a greater coordination role is limited by the fact that each member of the FSOC remains an independent agency, and the FSOC has little ability to require its members to take any specific actions they don't want to take. The FSOC does have the authority to override actions by CFPB, but the standard for exercising that authority is very high.[63] The FSOC also has the power to recommend actions to its members related to specific activities and products. An agency, however, is not required to accept any such recommendation.

An example of the FSOC's recommendation authority occurred in connection with the regulation of money market mutual funds. When the SEC could not reach agreement on a package of additional regulations to apply to money market mutual funds, then–SEC Chairman Mary Schapiro worked to convince the FSOC to propose recommendations for a package of reforms.[64] The SEC sought public comment on this issue, but has yet to take action on the matter.

In the end, the effectiveness of the FSOC and OFR cannot be gauged until it can be seen how the regulatory apparatus will respond and adapt to a future, potentially different kind of crisis. However, there are steps that can be taken to help improve our chances of better anticipating, preventing, or mitigating the impact of that next crisis.

Recommendation 3(a): Grant the FSOC authority to set standards and safeguards on activities or practices that present systemic threats

The task force recommends that the FSOC's authority under Section 120 of Dodd-Frank be strengthened to give it the power and responsibility to impose "heightened standards and safeguards" when a supermajority of the Council determines that an activity or practice likely poses a significant threat to our financial system.

Given the enormous economic and social costs associated with financial crises, the FSOC was vested with authority to respond to substantial threats to the financial system. Section 120 of the Dodd-Frank Act allows the FSOC to recommend that its member agencies adopt "new or heightened standards and safeguards" for "a financial activity or practice … if the Council determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit or other problems spreading."[65] As noted earlier, the FSOC used this authority when it recommended that the SEC adopt further reforms to address the systemic risk posed by money market mutual funds to the financial system.

Yet, the power to recommend is not the power to require action. FSOC member agencies are not required to follow the recommendations of the Council, which must rely on the moral suasion to convince an agency that receives recommendations to act on them. If the safety and soundness of the financial system is to be given the priority it should have, the FSOC should have the authority to act to respond to systemic threats.

Therefore, the task force recommends that the FSOC's authority under Section 120 be expanded to require member agencies to implement heightened standards and safeguards when an activity or practice constitutes a significant threat to the financial system. Such authority could have been used in the 2000s, for example, to improve loan underwriting standards that had deteriorated so much prior to the financial crisis or to raise capital and/or liquidity. This authority will not stop every systemic threat, but it will give regulators another tool to prevent them.

Recommendation 3(b): Empower the FSOC to mediate disputes among member agencies

The task force recommends that in cases where two or more agencies charged by Congress with writing rules or regulations cannot agree on a final rule more than 180 days after their congressionally mandated deadline for doing so, the determination of the final rules or regulations will be made by a vote of the FSOC.

Dodd-Frank mandated numerous instances where two or more agencies were required to jointly write and promulgate rules and regulations. Perhaps the most famous case was the so-called Volcker Rule regulations, with Congress giving rulemaking responsibility to five different agencies.[66] Regulators missed the deadline for adopting final rules to carry out the Volcker Rule by more than two years,[67] and the new regulations will now go into effect in 2015, three years after the deadline set in Dodd-Frank.[68] At one point in the process, it appeared possible that the regulators would issue multiple, potentially conflicting Volcker Rule regulations, an outcome opposed at the time by BPC's Capital Markets Task Force.[69] While joint rulemakings have the advantage of drawing on multiple perspectives, too many times the process has resulted in interagency friction and missed deadlines.

Section 112 of the Dodd-Frank includes as a duty for the FSOC to "facilitate information sharing and coordination among the member agencies and other Federal and State agencies regarding domestic financial services policy developments, rulemaking, examinations, reporting requirements, and enforcement actions."[70] In addition, Section 119 gives the FSOC authority to recommend a method to resolve disputes among two or more agencies.[71] Any recommendations of the FSOC, however, must be requested by at least one of the agencies involved in a dispute and are non-binding on the agencies.

The task force recommends giving the FSOC more active power to resolve disputes. In cases in which two or more regulators miss statutorily imposed deadlines for agreeing on rules or regulations by more than 180 days, the resolution of such interagency disputes would move into the hands of the FSOC. Each agency responsible for the joint rulemaking would be required to submit its proposed rule to the FSOC. The FSOC chair would have the option of advocating one of the options submitted by an agency or submitting an alternative proposal that combines elements from two or more proposed rules. The FSOC members would then vote on the set of options, using approval voting to decide on the final rule or regulation.[72]

In practice, this proposed authority should never have to be used. The threat of having rulemaking authority taken out of their hands should be a powerful incentive for agencies to reach agreement among themselves before deadlines elapse.

Recommendation 3(c): Focus regulators on institutions that pose the greatest potential systemic risk.

The task force recommends raising the threshold from $50 billion to $250 billion for bank holding companies to be subject to enhanced supervision due to their systemic importance, and to make the threshold presumptive.

Dodd-Frank automatically subjects all bank holding companies with more than $50 billion in assets to heightened prudential standards. The structure for this regulation is similar to that for non-banks that have been designated as SIFIs. This provision was put into place so that banks and non-banks that could generate substantial risk to the financial system by their failure would have a different and enhanced level of regulation applied to them.

Enhanced prudential standards for the largest, most systemically important financial institutions are appropriate. However, the task force believes that banks of about $50 billion are generally not systemically important—or at the least the threshold is arbitrary and does not take other important factors into account—and therefore the threshold for automatic application of heightened prudential standards is too low. The size of a bank's balance sheet is one important factor in determining the systemic risk it can generate. Adjusting the threshold should allow regulators to focus more resources on a smaller set of institutions that presents the greatest potential systemic risk.

The task force therefore recommends a new threshold for designating bank holding companies for enhanced regulation be set at $250 billion, above which institutions are generally more likely to be systemically risky than institutions of $50 billion in size.[73] Since this new threshold is also arbitrary, the task force recommends adding regulatory flexibility in applying it to individual institutions. Therefore, the new line at $250 billion would not be an automatic threshold like the current $50 billion line.[74] Instead, institutions above $250 billion would be presumed to be systemically important, but could bring evidence to appeal their designations to the FSOC. Similarly, institutions below $250 billion would be presumed to not be systemically important, but the FSOC could designate them as SIFIs based on available evidence. In weighing evidence in either situation, the FSOC would use a process similar to the three-stage process it uses in deciding on non-bank SIFI designations. The FSOC would consider five factors in determining whether an institution is systemically risky: an institution's size, interconnectedness, substitutability, leverage, liquidity risk, and maturity mismatch.[75] A vote to overturn this "positive" or "negative" presumption for institutions either below or over the $250 billion line would require a two-thirds vote of FSOC membership, the same as it is now for designation of non-bank financial institutions.

Recommendation 3(d): Realign Voting Membership of the FSOC

Dodd-Frank was right to include input from a wide variety of sources on the FSOC, but including ten members with equal votes (aside from the chairman) was more a concession to political reality than a recipe for an efficient structure. For example, while it is useful to have representation on the FSOC from the NCUA, it makes little sense for the NCUA to have a vote equal to the Federal Reserve on all matters before the Council, particularly when the NCUA does not oversee a single institution that meets the criteria established by Congress or the FSOC as requiring enhanced supervision due to systemic importance.

To align the Council's membership more closely with its mandate, the task force recommends that the following changes be made to the FSOC's voting membership:

1. The director of the OFR should become a voting member. As part of the task force's plan to make the OFR more independent and powerful, it makes sense to raise its profile within the FSOC and give it more say on macro-prudential matters.
2. The director of the FIR should replace the FIO director on the FSOC and become a voting member. With the elevation of the FIO to the status of a full-fledged regulatory body with oversight of a national insurance charter, the FIR should be similarly elevated to voting status within the FSOC, particularly since it will have jurisdiction over at least two SIFIs.
3. The chair of the NCUA should become a non-voting member. Credit unions are an important part of the U.S. financial system, but they generally are small and do not figure into macro-prudential discussions. To the extent they do, a credit union voice will still be represented on the FSOC, but without a vote.
4. The director of the PRA should replace the director of the OCC.
5. The chair of the new capital markets regulator should replace the chairs of the SEC and CFTC.

Taken together, these actions would result in an FSOC with the same number of voting members as it has today, but better focused on macro-prudential issues. The FSOC would have one fewer non-voting member than it has now.

Recommendation 3(e): Improve FSOC Accountability and Transparency

Because of the new powers the task force recommends conferring on the FSOC, the task force believes it is particularly important to improve the Council's accountability and transparency. The task force recommends fully implementing the GAO's 2012 recommendations to accomplish this goal.[76] These recommendations include creating a process for better communicating its discussions to the public; developing and utilizing advisory committees as authorized under Dodd-Frank and as envisioned by the FSOC's 2010

Dodd-Frank implementation plan;[77] performing economic impact assessments on non-bank SIFI designations; improving its strategic-planning and performance-measurements systems; and assigning accountability for monitoring recommendations made in the Council's annual reports. The use of more open forums to discuss FSOC business would also be helpful. The FSOC should also consider releasing additional details about the closed-door conversations that occur during their regular meetings, much like the Federal Reserve does when it release detailed minutes from its Federal Open Markets Committee meetings.

Recommendation 3(f): Provide Greater Independence to the OFR

The task force recommends that the OFR be removed from the Treasury Department and established as an independent entity to maximize the OFR's ability to identify systemic threats in an unbiased and independent manner.

The OFR was set up as an office within the Treasury Department. In fact, the Treasury's organizational chart shows the director of the OFR reporting to the undersecretary for domestic finance.[78] While this structure may seem to guarantee that the OFR would be at least to some degree captive to the culture and outlook of the Treasury Department, the OFR has latitude to determine with how much independence it will act.[79] The OCC is set up as a separate bureau within Treasury, but it has a long tradition and history of operating independently from the Treasury with respect to the regulation and supervision of national banks.

U.S. financial regulators were set up as independent agencies to give their decision-making a measure of insulation from political influence. Because the OFR has the responsibility to provide unbiased information and critical analysis and insights to the FSOC and other regulatory agencies, freedom from politics is perhaps more important for it than any other agency.

Because of its unique role among financial regulators, it is critical that the OFR be established structurally in a way that allows and encourages it to offer objective, thoughtful, far-seeing, and timely analysis and recommendations that are as free from political influence as possible. The task force therefore recommends that the OFR be removed from the Treasury Department and set up as an independent entity. This action would allow the OFR to speak unambiguously with its own voice on systemic, macro-prudential matters.

The OFR should also consider whether it should remain headquartered in Washington, DC. It may be that locating in New York—or Boston, Chicago, or San Francisco—would give the OFR the best perspective on its portfolio of issues. The OFR should choose its headquarters—and potentially regional, satellite offices—based in large part on which location gives it the best opportunity to attract and retain top-level talent, whether from the academic, private-sector, or nonprofit communities. Such considerations are one reason the Federal Reserve maintains a strong Reserve Bank in New York. Over the years, there have been many talented people who would have had no interest in working in Washington at the Federal Reserve Board who did decide to work for the Federal Reserve Bank of New York.

Recommendation 3(g): Grant greater independence for OFR and FSOC budgeting

The task force recommends that a two-thirds vote of the FSOC be required to veto the OFR's budget.

The OFR is responsible for setting the budgets for itself and the FSOC. Dodd-Frank gave authority to the OFR to assess SIFIs at a level to cover that budget, with the assessment schedule subject to approval of the FSOC.[80] So, while the OFR and FSOC have control over their own funding, it is subject to a check by FSOC members.

Such checks are important to promote accountability. However, if the OFR acts in the independent role that the task force envisions, it is conceivable that it will at times publish opinions and observations that are critical of FSOC member agencies, which could cause those agencies to want to limit the OFR's budget. In the interest of ensuring the independence of the OFR, the task force recommends that a two-thirds vote of the FSOC be required to veto the OFR's budget, rather than requiring a simple majority of FSOC members to approve it.

Recommendation 3(h): Centralize data collection

The task force recommends that the OFR be designated as responsible for coordinating the collection of all financial data by independent financial regulatory agencies. Such collection should be done in consultation with other regulators to ensure that a comprehensive suite of data is collected. This change would create a single point of contact for data collection for regulated entities and help to minimize overlapping, redundant, and conflicting data requests.

The fragmented nature of the U.S. financial regulatory system can lead to a lack of coordination among agencies in a variety of functions, including data collection from regulated entities. Overall regulatory effectiveness would be improved, and confusion among regulators and regulated entities reduced, by allowing the OFR to take a leading role in data collection across agencies.

Recommendation 3(i): Create a financial war-gaming center[81]

The OFR is charged with "seeing around corners" to help regulators understand and predict which current risks could lead to future scenarios of financial distress or crisis. The U.S. military performs a similar function in the national security field; it must anticipate where future threats to American security may arise in the near- and longer-term.

The Pentagon has numerous tools at its disposal to help it better understand and predict such threats, one of which is war-gaming, in which theories about threats and responses can be tested routinely in a simulated environment. The OFR should borrow a page from military planners and create a financial war-gaming center, which would bring together thought leaders from academia, the private sector, government agencies, and think tanks to simulate and respond to potential systemic threats.

A war-gaming center's first mission would be to model scenarios based on a continuous and broad horizontal review of potential long-term market risks. It should pay attention to risks that could give rise to high-impact events, including low-probability "black swan" events. The center's second mission would be to identify risks of regulatory failure, including gaps in oversight and risks of regulatory capture. Finally, the center would help the OFR present options to policymakers, regulators, and market participants to respond to potential emerging risks. In theory, this kind of analysis would help all stakeholders to adjust before more drastic and potentially costly actions are necessary.

Although it is impossible to accurately and precisely anticipate all future risks, a financial war-gaming center would make stakeholders more aware of emerging risks and help them to communicate better and think more creatively in real time about those risks. The more thinking that can be done about threats before they occur, the better chance both policymakers and regulators have to be prepared for future systemic stress events.

These steps will improve the OFR's efficiency and ability to provide the best possible information and recommendations to the FSOC and our other financial regulators.

Taken together, these recommendations will add "teeth" to enhance the critical functions of the FSOC and OFR, improve regulatory efficiency, and maintain a proper balance between the FSOC and OFR, and the FSOC's member agencies.

Recommendation #4: Create a Single Capital Markets Regulator

The task force recommends the creation of a single, modern Capital Markets Authority that operates across the equities and futures markets for all capital market instruments and providers.

Calls in recent decades to merge the CFTC and SEC into a single capital markets regulator have been numerous. The logic for doing so has become harder to refute since it has been more difficult to clearly define the space supervised by each agency since Congress created the CFTC as a separate agency in 1974. Innovations and techniques have cross-pollinated and blurred the line between securities and futures trading, leading to turf battles between the two agencies and confusion among those regulated by them. Disagreements between the two agencies can cause friction with U.S. trading partners. The United States is the only OECD country without a single capital markets authority. International cooperation is increasingly important and being able to speak with a unified voice on such issues on the global stage is a worthwhile and achievable goal. The task force believes, therefore, that there is little benefit to keeping the CFTC and SEC as separate entities. Furthermore, significant gains for the financial system, financial institutions, and their customers would be realized by the merger of the two agencies. As the Paulson Blueprint stated:

> Product and market participant convergence, market linkages, and globalization have rendered regulatory bifurcation of the futures and securities markets untenable, potentially harmful, and inefficient. The realities of the current marketplace have significantly diminished, if not entirely eliminated, the original rationale for the regulatory bifurcation between the futures and securities markets.[82]

The reasons a merger has not taken place are well known. The SEC is, like most financial regulators, under the purview of the Senate Banking Committee and House Financial Services Committee, while the CFTC is subject to the jurisdiction of the Senate Agriculture Committee and the House Agriculture Committee. While the overlap of securities and futures markets is substantial, each pair of committees is understandably reluctant to cede its authority in an area that impacts its different constituencies.

Although past attempts at a merger have shown it to be politically difficult, political realities can unexpectedly shift, particularly in response to financial crises. Moreover, the potential advantages to a merger are significant and include: a clearer regulatory structure for U.S. capital markets; eliminating the ongoing friction between the CFTC and SEC; a single U.S. capital markets voice in international negotiations; and more efficient markets from reducing duplicative oversight requirements.

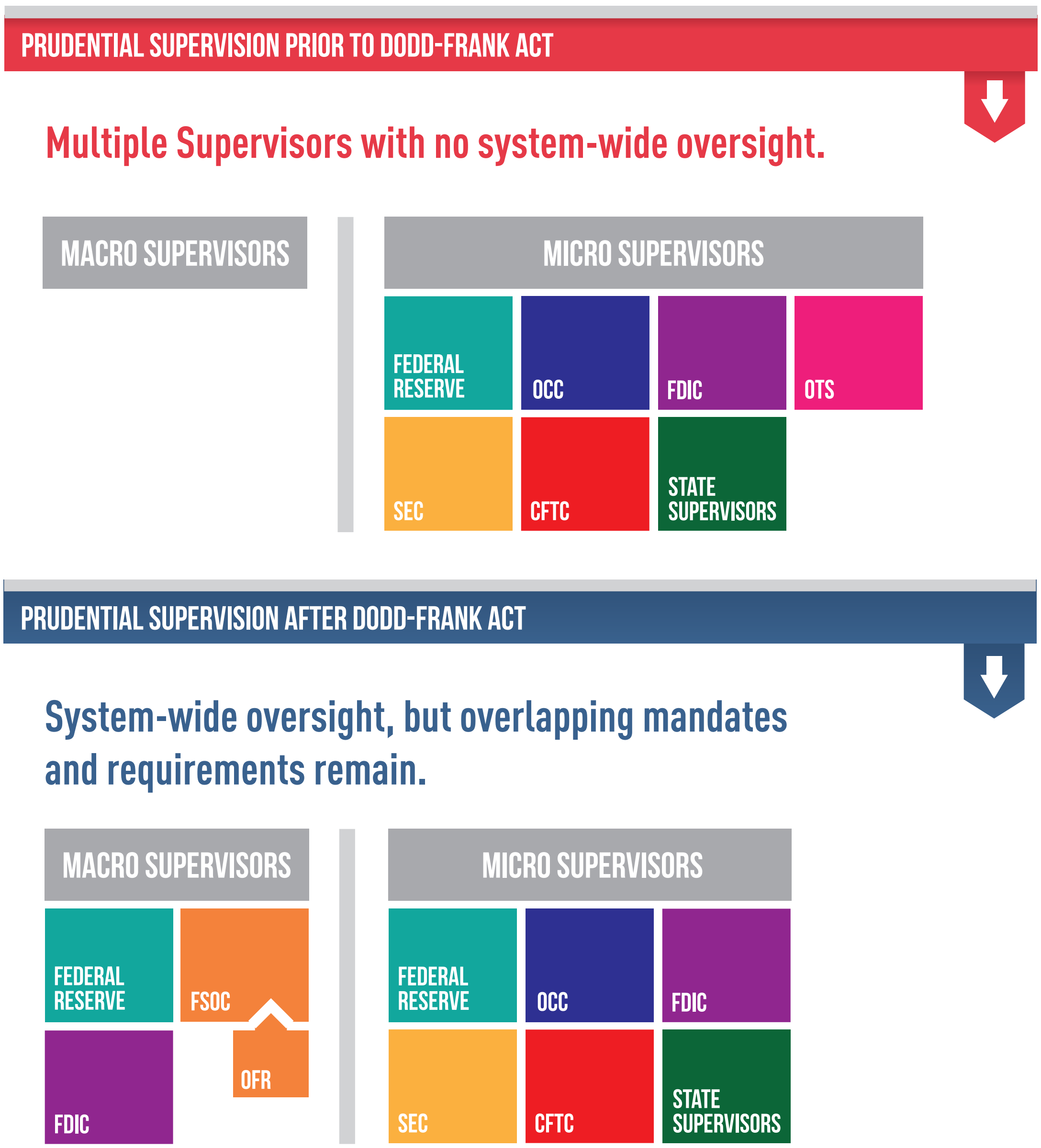
The task force, therefore, recommends that the CFTC and SEC be merged into a single Capital Markets Authority within two years. The merged entity would retain the commission structure that is familiar to both agencies and adopt the nomination rules of the SEC, which allows for presidential appointment of its chair from existing, Senate-confirmed regulators rather than requiring a separate nomination and confirmation for the chairmanship required under the Commodity Futures Trading Commission Act. The new CMA would fall under the jurisdiction of the Senate Banking and House Financial Services committees, as most of the trades the agency would oversee would traditionally fall into the category of financial services.

As an interim step toward full consolidation, **the task force also recommends that the CFTC and SEC immediately begin to conduct their board meetings jointly**. This will allow the two agencies to better prepare for the logistical and cultural changes that will be necessary to effectuate the merger. It also will help to achieve the goal of speaking with a unified U.S. voice on capital markets regulatory issues at an international level.

Proposed Task Force Structure

The two figures on the following pages depict key aspects of the U.S. regulatory architecture in three stages: prior to the Dodd-Frank Act; the current, post-Dodd-Frank structure; and the new structure recommended by the task force. Figure 2 shows changes in agency responsibility for micro- and macro-prudential regulation. Figure 3 describes changes to the regulation of selected kinds of financial activities over the same stages. The task force's plan results in a more streamlined regulatory structure that is more conducive to financial stability and economic growth.

Figure 2. Prudential Supervision[83]

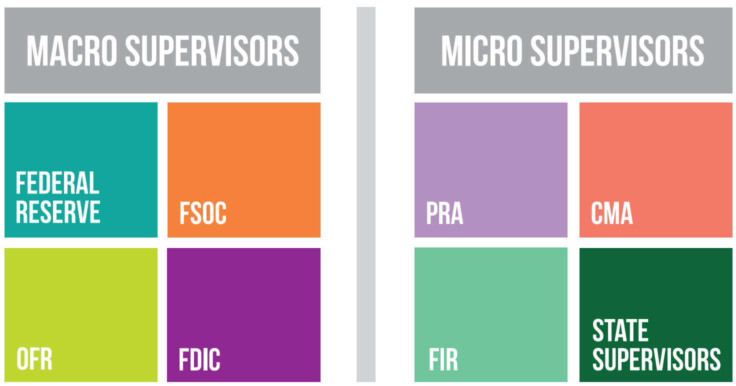


LEGEND

FDIC = Federal Deposit Insurance Corporation
OCC = Office of the Comptroller of the Currency
SEC = Securities and Exchanges Commission
CFTC = Commodity Futures Trading Commission
OTS = Office of Thrift Supervision
FSOC = Financial Stability Oversight Council
OFR = Office of Financial Research
FIR = Federal Insurance Regulator
PRA = Prudential Regulatory Authority
CMA = Capital Markets Authority

PRUDENTIAL SUPERVISION PROPOSED BIPARTISAN SOLUTION

A streamlined solution putting oversight with fewer supervisors eliminates complexity and encourages efficiency.



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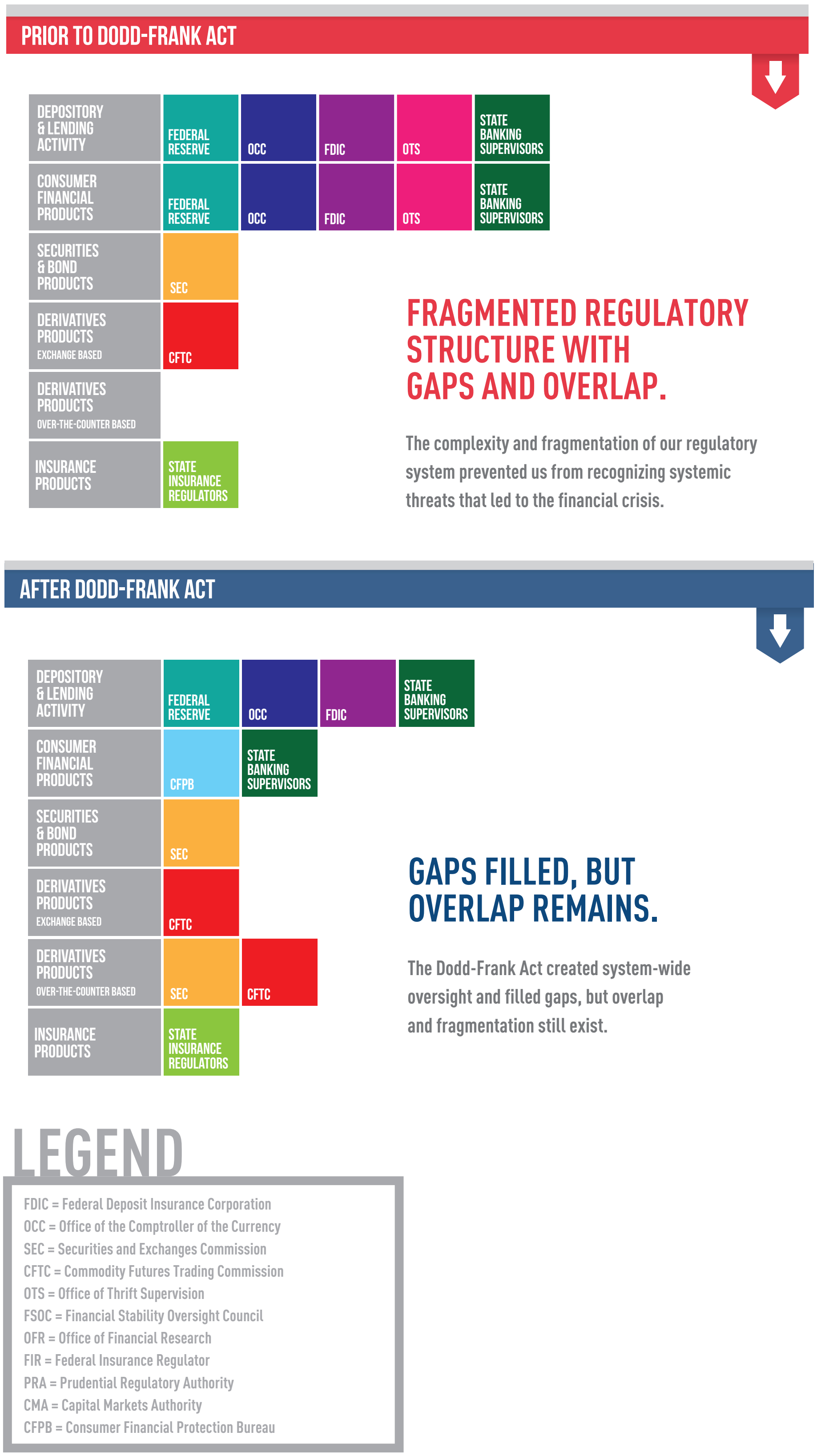
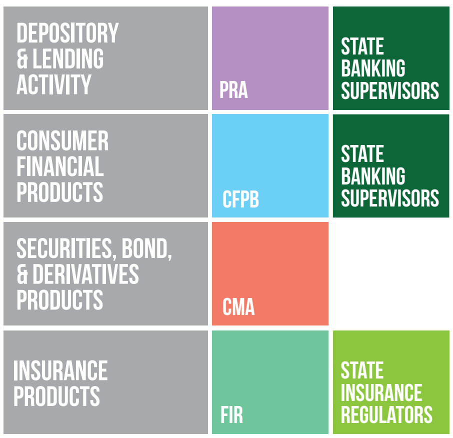
OFR = Office of Financial Research
FIR = Federal Insurance Regulator
PRA = Prudential Regulatory Authority
CMA = Capital Markets Authority

Figure 3. Regulation of Financial Activities and Products[84]



PROPOSED BIPARTISAN SOLUTION



STREAMLINING REGULATION

BPC's plan consolidates and empowers regulatory agencies with clear lines of jurisdiction. This approach reduces complexity and inefficiency, and ensures a safer financial system.

LEGEND

FDIC = Federal Deposit Insurance Corporation
OCC = Office of the Comptroller of the Currency
SEC = Securities and Exchanges Commission
CFTC = Commodity Futures Trading Commission
OTS = Office of Thrift Supervision
FSOC = Financial Stability Oversight Council
OFR = Office of Financial Research
FIR = Federal Insurance Regulator
PRA = Prudential Regulatory Authority
CMA = Capital Markets Authority
CFPB = Consumer Financial Protection Bureau

Recommendation #5: Ensure Independent Funding for All Financial Regulatory Agencies

The task force recommends that the SEC and CFTC fund themselves through the existing SEC fee and assessment structure, with any excess funds being returned to the Treasury.

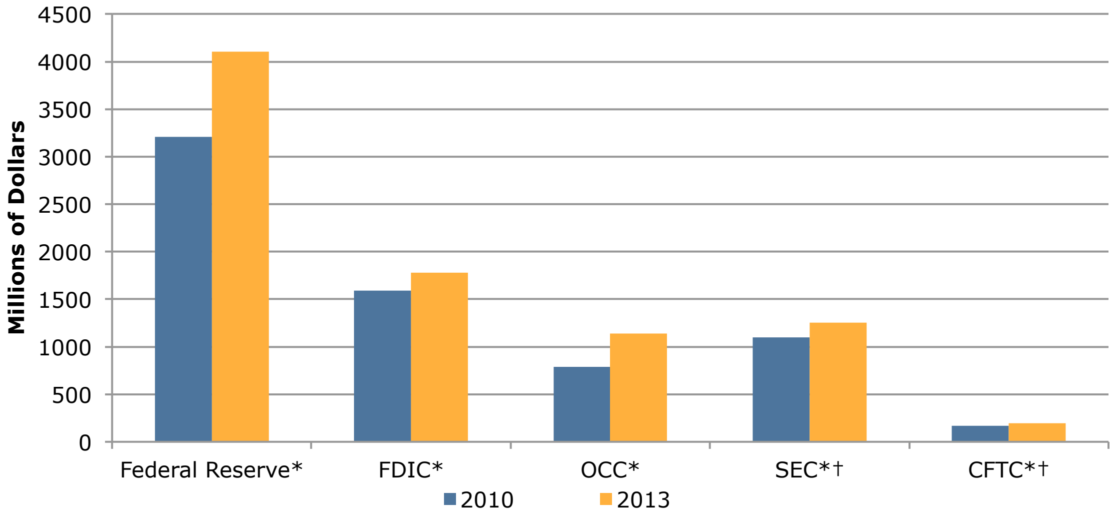
The U.S. financial regulatory system was deliberately constructed to give a significant degree of independence to its constituent agencies, in large part to insulate them from political influence, especially during times of crisis. It is difficult, however, for an agency to remain free of such political influence without independent funding.

The Federal Reserve can generate the money it needs through its income from seigniorage, interest on foreign currency investments held by the Federal Reserve system, fees received for services provided to depository institutions, and interest on loans to depository institutions. An agency like the OCC levies assessments on the national banks it regulates to fund itself. By contrast, the CFTC and SEC are funded through the appropriations process, with the assessments and fines they collect returned to the Treasury rather than being used to fund those agencies. This has resulted in both agencies being underfunded.

In its proposed Fiscal Year (FY) 2014 budgets, the CFTC requested $315 million, while the SEC requested $1.674 billion.[85,86] The budget agreement reached by House and Senate leaders in January of 2014 for the FY 2014 budget contained far less for each agency: $215 million for the CFTC and $1.35 billion for the SEC.[87] These numbers represent increases of less than 5 percent for the CFTC and about 2 percent for the SEC over their FY 2013 budgets.[88] These two agencies faced further cuts in FY 2013 from sequestration. The SEC’s FY 2013 budget was cut by $66 million, from $1.321 billion to $1.255 billion, while the CFTC’s FY 2013 budget was cut by about $11 million, from $205 million to $194.6 million.[89]

The budgets of the SEC and CFTC have grown slowly since the financial crisis. From 2010 to 2013, the CFTC’s budget grew by about 16 percent, while the SEC’s grew by about 14 percent. This is especially slow in light of the financial crisis and the substantial new responsibilities assigned to each agency by Dodd-Frank. Each agency’s budget has increased more slowly than the FRB or OCC, which increased their budgets by 28 percent and 44 percent, respectively, from 2010 to 2013. The growth of each is shown in Figure 4 below.[90]

Figure 4. Financial Regulator Operating Budgets, 2010-2013



* Actual operating expenses, 2010-2012. Budgeted operating expenses, 2013.
† Figures account for sequestration reductions in operating budget.

Many, including former CFTC Chairman Brooksley Born and former SEC Chairman William Donaldson, argue that to truly be independent, financial regulators require independent funding not subject to congressional appropriation.[91] Former SEC Chairman Mary Schapiro has urged congressional leadership to allow the agency to independently fund itself through the fees it collects, which typically exceed appropriations by a substantial margin.[92] Former CFTC Chairman Gary Gensler testified that his agency had jurisdiction over a futures market five times larger than in the 1990s and now oversees a swaps market eight times larger than the futures market, all with a budget only 8 percent greater than in the 1990s.[93] In February 2013, acting SEC Chair Elisse Walter said the SEC would not be able to adequately address the issues mandated to it by Dodd-Frank without a significant budget increase.[94]

Opponents of independent funding argue that past agency failures and inefficiencies justify greater congressional funding oversight; that hiring more regulators would produce unnecessary red tape and cost for institutions and investors; and that funding the CFTC through user fees would be a backdoor tax increase.[95]

While these concerns are valid to a point, their impacts should not be overstated. Agencies like the FRB and OFR, which already have independent funding authority, must still report regularly to Congress, which can legislate changes in the way financial regulators are funded and governed and has done so. Overzealous regulation should always be a concern, but so too should too-lax regulation, specific instances of which contributed to the financial crisis. Finally, it is important that agencies fund themselves only to the extent necessary to complete the work Congress has asked of them.

The task force agrees that independent financial regulators must have sufficient resources to complete the job that Congress has given the through the Dodd-Frank Act and other actions. The task force also believes that the creation of independent financial regulators was a wise and essential element of a well-functioning financial regulatory structure. Therefore**, the task force recommends that the SEC and CFTC be given the authority by Congress to collect and keep funds generated through fees and assessments to fund their own operations**. The merged capital market regulator that the task force recommends should be funded by adjusting existing SEC assessments to match budget needs rather than establishing new assessments and fees in areas overseen currently by the CFTC.

Recommendation #6: Improve International Cooperation and Cross-Border Regulatory Outcomes

The task force recommends that the FSOC review all provisions of Dodd-Frank that have extraterritorial effects and make recommendations to the Congress and/or financial regulators for actions to prevent unnecessary and avoidable negative impacts on international cooperation, financial stability, competitive opportunity, and economic growth.

Financial markets are global in their reach, so the actions of regulators in one country affect financial institutions in multiple jurisdictions. The actions of U.S. regulators carry special weight around the globe due to the reach of U.S. markets and U.S.-based financial institutions. Dodd-Frank raised a number of important issues about the extraterritorial application of U.S. law that to date have not been adequately considered by regulators or policymakers.

Confusing, duplicative, or contradictory regulations can have a negative impact on growth and the operation of global capital markets. Foreign governments have been critical of U.S. regulators for what they see as an insufficient effort at coordinating rulemaking in a number areas, including implementation of the Federal Reserve's rules on Foreign Banking Organizations.[96] Lack of cooperation can lead to "ring-fencing" of financial institutions in a way that "comes at a cost for banking groups and the efficiency of the overall global financial system."[97] The Financial Stability Board (FSB) wrote on the subject of over-the-counter (OTC) derivatives reform that:

> Uncertainties about the treatment of cross-border activity…under various jurisdictions' regimes continue to be a concern for market participants as regulatory requirements take effect. … [I]n light of the global nature of OTC derivatives markets, cross-border coordination is needed to avoid unnecessary duplicative, inconsistent or conflicting regulations. Where there are conflicts, inconsistencies and gaps in the regulation of cross-border OTC derivatives activities, this may incentivize market participants or infrastructure providers to reorganize their activity along jurisdictional lines. Regulatory impediments to cross-border activity might reduce market participants' opportunities to trade and affect market functioning. Similarly, a

> failure to resolve barriers with respect to trade reporting … would undermine authorities' capacity to monitor domestic and global markets.[98]

U.S. regulators have their own criticisms of foreign regulators, of course. It is not the purpose of this report to adjudicate which side is right and wrong in each case. What is important is that U.S. regulators work in good faith with their counterparts in other jurisdictions to harmonize and make the regime of international regulation most effective and supportive of economic growth, safety and soundness, and consumer protection. The task force joins the FSB in urging, "regulators in all jurisdictions to clarify their respective approaches to cross-border activity, and for authorities to work together to resolve conflicts, inconsistencies and gaps."[99]

The task force's recommendation envisions the FSOC's conducting its review and making its recommendations as part of the Council's broad mandate for macro-prudential supervision and surveillance across markets.

Issues for Future Consideration

The regulatory architecture of the U.S. financial system is a complex subject with many variables. The task force considered many of these questions in the course of developing this report, but offered recommendations on only a select number of the more pressing issues we studied. There are a few outstanding issues, however, that the task force believes should be more fully considered in the future when more information and perspective is available to do so.

Investor protection: The first is whether it would make sense to move investor protection responsibility from the SEC to the newly created CFPB. The "twin peaks" model of financial regulation vests safety-and-soundness responsibilities within one agency and business conduct oversight in another. Investor protection, as consumer protection, falls under business conduct, and moving jurisdiction for it to the CFPB may make for a cleaner, more philosophically coherent regulatory structure. The task force, however, thought it would be better to wait to determine the wisdom of such a move, giving the CFPB more time to develop.

Governance structure for financial regulators: Another issue that has received much attention in the past few years is whether financial regulators should be run by commissions or single directors. The task force has proposed the creation of a PRA with a commission, but that does not necessarily mean that a commission structure would be the best choice for every agency.

The FDIC is unique among financial regulators in that, by statute, two of its members are from other agencies: the directors of the CFPB and OCC.[100] The FDIC had a three-person board until 1989, when the director of the OTS and a newly created vice chairman were added to the board. Among the options for changing the FDIC's leadership structure would be to go back to a three-person board, make the current five-member board independent without membership from other agencies, or change it to a single-director structure. If the current five-person board remains, the director of the OCC would be replaced by the chairman of the PRA in the task force's plan, and the CFPB director would remain. One could also ask if a member of the FRB should be one of the FDIC's board members instead.

By statute, one of the FDIC's board members must have state bank supervisory experience.[101] The task force believes this requirement brings a much-needed perspective to the FDIC's board. With the Federal Reserve taking on a stronger macro-prudential role in the task force's plan, lawmakers should consider whether the FRB should also have a requirement that one of its governors must have state bank supervisory experience.

Conclusion

The financial crisis revealed serious weaknesses in the U.S. financial regulatory structure. Fragmentation led to gaps in oversight and regulation, duplication of efforts, and lack of clarity for stakeholders. The Dodd-Frank Act attempted to address some of these issues and has made progress in actions such as eliminating the OTS and consolidating business conduct regulation in the CFPB.

Much more progress, however, must be made. Further consolidation of prudential bank examination teams and regulatory agencies would improve the quality, efficiency, and accountability of the supervision of financial institutions. A single capital markets regulator with independent funding would mean greater efficiency, reduced friction, and a clearer U.S. capital markets voice for domestic and international stakeholders. An optional national insurance charter paired with a new and knowledgeable federal regulator would rationalize oversight of large, national insurance companies and put the U.S regulatory system on an equal footing with other countries in this area. Finally, while the creation of the FSOC and OFR were positive steps, the two entities need to be redesigned in a way that will allow them to effectively fulfill their mandates and realize their full potential.

There is a growing realization that Dodd-Frank missed a major opportunity to further consolidate and streamline the U.S. financial regulatory structure to enhance the financial markets that support the economy. The task force realizes that some of the recommendations presented in this report will be politically difficult to put into effect in the short-term. It will be far more problematic, however, if policymakers and stakeholders are forced into making such tough decisions during or after another financial crisis that results in part from defects in the current regulatory architecture. Instead, policymakers should act sooner rather than later to improve and strengthen the financial system through the adoption of these, and potentially other, carefully considered recommendations.

Appendix A: A Brief History of the U.S. Financial Regulatory System

The United States has consistently crafted its federal financial regulation structure in response to current problems or crises without much serious reflection on whether the various parts of that structure interact appropriately.[102]

The foundation of the U.S. financial regulatory structure began with the debate over the creation of a central bank. In 1791, the United States was a fragile collection of states that were heavily indebted and dealing with high levels of inflation. In response, Congress established 20-year charters for both the First Bank of the United States and the Second Bank of the United States. The debates over the creation of both institutions were contentious and, by 1836, political forces had shifted and eliminated the Second Bank. The need for a central bank would not be seriously revisited until the 20th century, and during that time, the United States experienced financial crises in 1873, 1884, 1893, and 1907.[103]

A combination of factors, including the pressing need to finance the Civil War and inconsistent state bank regulation, led to the passage of the National Bank Act of 1863. The Act, one of the signature economic policies of the Lincoln administration, created a federal charter for "national banks" and brought with it the nation's first federal regulator: the OCC.

The financial crisis of 1907 revived the debate over the need for a central bank. In that year, the failure of the Knickerbocker Trust Company triggered bank runs across the nation, and confidence in the system was restored only after financier J. Pierpont Morgan stepped in to provide needed liquidity. While Morgan was able to stem this financial panic, there was broad realization that a new financial regulatory structure was needed. This led to the passage of the Federal Reserve Act of 1913.

Such a commitment to central banking had been in place for hundreds of years in other countries. For instance, the Swedish central bank (Riksbanken) has operated since 1609. The Bank of England was created in 1694, and the French central bank, Banque de France, was established under Napoleon Bonaparte in 1800.

The creation of the third central bank in U.S. history was a major turning point in the government's role in the financial system. A hybrid of public and private enterprises (the regional Federal Reserve Banks are private, non-governmental entities), the Federal

Reserve System gained political independence and power since its creation. However, the Fed was widely criticized for not only failing to stop, but having accelerated the financial panic of 1929, which culminated in the Great Depression.[104]

The Great Depression catalyzed a series of major financial regulatory reforms, the legacy of which still shape our financial market structure today. That crisis led to the passage of legislation such as the Banking Act of 1933, also known as the Glass-Steagall Act, which established the FDIC and deposit insurance; the Securities Act of 1933 and the Securities Exchange Act of 1934, which were passed to combat the fraud and poor record-keeping of companies selling stock; and the Federal Home Loan Bank Act of 1932, which created the Federal Home Loan Bank System, a parallel structure to the Federal Reserve System for thrifts.[105]

After the New Deal reforms, it took more than 20 years for new major banking legislation to materialize. In 1956, the Bank Holding Company Act was passed to prevent the rise of financial conglomerates. The Act gave the power to regulate bank holding companies to the FRB. That law, however, only prohibited affiliations between banks and commercial firms if there was more than one bank in the organization. The Bank Holding Company Act Amendments of 1970 were passed to extend the law's prohibitions to companies that controlled just a single bank.[106]

The regulation of financial instruments also has followed the crisis-response model. While regulation of grains and other commodities had been in place as early as 1848, it was record-high prices in commodities in 1973 and 1974 combined with concerns about excessive speculation and price manipulation that led to passage of the Commodities Exchange Act and the creation of the CFTC to provide greater regulatory oversight of these evolving markets.[107] With the increasing sophistication of financial products, the regulation of contracts under the CFTC's jurisdiction has only grown in importance.

The S&L crisis that began in the 1980s set in motion the widespread failure of savings and loan associations, also known as thrifts. In response, Congress enacted two major pieces of legislation: The Financial Institutions Reform, Recovery and Enforcement Act of 1989 and the Federal Deposit Insurance Corporation Improvement Act of 1991.[108] These new reforms eliminated the former federal thrift regulator, the Federal Home Loan Bank Board, for failing to better supervise thrifts leading up to the crisis. In its place, Congress established the OTS, which chartered, supervised, and regulated all thrifts from 1989 until its elimination in Dodd-Frank. Further, these reforms merged the insurance fund for thrifts and banks, and created a procedure called "prompt corrective action" that required the FDIC to take increasing regulatory action as the condition of a bank worsened. These laws also required the FDIC to implement a least cost resolution process and generally prohibited open-bank assistance, with the caveat of a systemic risk exception.[109] That exception would not be triggered until the most recent financial crisis.

A few years later, Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which fundamentally altered the U.S. banking industry by allowing banks to more easily operate in multiple states. This federal response that lifted geographic restrictions on banks has been described as the final act in a lengthy effort by states to ease and lift such restrictions. For instance, in 1975, only 14 states permitted banks to have branches statewide, and no state allowed out-of-state bank holding companies to buy intra-state banks. By 1990, 47 states permitted banks to have branches statewide, and 49 states allowed out-of-state bank holding companies to buy intra-state banks.[110]

This changed the landscape of finance in the United States, resulting in a wave of financial institution mergers. While nearly 15,000 regional and local banks and thrifts existed in 1990, that number shrank to roughly 8,000 by 2009.[111] In the process, the largest banks continued to grow both in size and in relative share of assets of the financial system.

In another move intended to deregulate the financial industry in order to spur greater innovation and growth, Congress passed the Gramm-Leach-Bliley Act (GLB). [112] In 1999, GLB repealed sections 20 and 32 of the Glass-Steagall Depression-era separation of commercial and investment banking and allowed insurance and banking companies to affiliate.[113] One of the major theories underpinning GLB was the desire to create “financial supermarkets” where consumers could enjoy the benefits of economies of scale and scope that supporters argued were created by larger financial institutions.

Appendix B: How a Fragmented Regulatory System Contributed to the Financial Crisis

Even the best designed regulatory systems become less effective over time as financial markets adapt to changing customer needs and technological advances. This dynamic especially applies when overseeing global financial markets that have in recent decades experienced rapid innovation, evolution, and growth. The coverage that national regulators have over all aspects of the global financial system, and the accurate knowledge of, and insight into, how financial markets and firms operate and behave continually erodes over time because of these changes. This erosion ultimately leads to gaps in regulatory oversight and to a regime that cannot prudently, optimally, and at times effectively or efficiently, regulate financial firms and markets.

Many observers have argued that the biggest regulatory gaps were found in the so-called "shadow banking" system, which steadily grew in the years leading up to the crisis. The sector comprises a wide array of non-bank companies that provide bank-like services. Examples include money market mutual funds, broker-dealers, non-bank mortgage loan originator, payday lenders, hedge funds, and private label loan securitizers. One study estimates that shadow bank liabilities reached $22 trillion in mid-2007, before falling by about $5 trillion by 2011. Bank liabilities have grown steadily since the roughly $14 trillion they measured in 2007, so that today they outpace shadow banking liabilities for the first time since the mid-1990s.[114] Because shadow banks are not fully licensed commercial banks, these companies are not subject to some or all of the rules put in place to ensure the safety and soundness of banks with whom they compete daily.

Shadow banking institutions also do not have access to the Federal Reserve's discount window and government-guaranteed insurance on deposits. The absence of these stabilizing factors is perhaps the primary reason that several major components of the shadow banking system faced collapse during the height of the financial crisis. Market participants and regulators lacked a full understanding of the systemic risk posed by these components. Federal regulators intervened in response to the crisis to prop up a number of shadow banking sectors—for example, by guaranteeing money market mutual fund shares and bringing the largest broker-dealers into the regulatory safety net through acquisitions of broker-dealers by banks, or by broker-dealers electing to become bank holding companies.

They did so in order to stabilize the broad financial system, leading many to question whether these sectors already were covered by an implicit federal government safety net (the "too-big-to-fail" problem).

In other cases, gaps can open and widen over time in the more regulated space of commercial and consumer banking. Mortgage lending by banks, thrifts, and state-licensed loan originators, for example, has long been subject to extensive but fragmented oversight and regulation. That did not stop major problems from originating within each area, however, as regulators either did not see or fully understand the problems that were developing in the housing markets prior to the financial crisis, or do enough to mitigate their impact. There was no entity responsible for looking at potential problems that might be building across multiple sectors of the entire financial system.

Multiple and sometimes overlapping examination teams from several agencies also presented difficulties in identifying risks leading up to the financial system. Banks were supervised prior to the crisis by the FRB, OCC, FDIC, OTS, and state regulators, and sometimes by more than one at a time. This fragmented structure raised the amount of communication required if these agencies were to properly share their knowledge, specialized training, and other expertise to be most effective in spotting signs of trouble at supervised institutions.

Three examples of how regulatory gaps and lack of regulatory coordination contributed to the financial crisis are highlighted below.

The Mortgage Market and Securitization

The volume of poorly underwritten mortgages skyrocketed in the middle of the 2000s and was a major cause of the financial crisis. Subprime loans, which made up about 15 percent of mortgage originations in 2001, increased to nearly 50 percent of total originations by 2006, not coincidentally the peak of the housing price bubble.[115] This boom in borrowing was facilitated by low interest rates, a surge in home equity loans, and new mortgage products that only made sense assuming a perpetual increase in housing prices.[116]

The growth in subprime mortgage lending also was due to the absence of uniform lending standards and comprehensive oversight of the mortgage lending industry. It has been estimated that a majority of the subprime loans originated in 2004 and 2005 were originated by state-licensed lenders that were not subject to the supervision and regulation of the federal banking agencies until near the end of the housing boom.[117] For example, the FRB waited until 2007 to exercise its authority under the Home Ownership and Equity Protection Act of 1994 to propose rules to limit unfair and abusive lending practices.[118]

The risk inherent in these poorly underwritten loans was then spread throughout the financial system as investors purchased securities backed by subprime loans. A number of large financial institutions securitized these subprime mortgages, in many cases substantially underestimating the chances the securitized bonds could drop significantly in value. Ratings on these securities, provided by SEC-recognized rating agencies, also failed to reflect the risk inherent in the bonds. Falling prices after 2006 unraveled the convoluted and poorly understood threads that held together the U.S. mortgage securitization market through the mid-2000s. The amount of outstanding private-label mortgage debt, which peaked in 2007 at $2.2 trillion, stood at a mere $909 million in early 2013.[119] Although some regulators warned that a housing bubble was forming, their agencies either did not fully appreciate the extent of the problem, or did not act on their knowledge in a timely fashion.

In some cases, problems were directly within the purview of bank supervisors. Large bank holding companies had "roomfuls of regulators" overseeing them for safety and soundness, from multiple federal and state agencies.[120] These regulators, unfortunately, failed to understand the risk associated with some of the complex new financial products that undergirded the complex system of mortgage originations and securitizations, and at the time lacked the authority to take corrective action when they did understand the risks.

When GLB was enacted, Congress gave the FRB umbrella regulatory powers over holding companies and their non-banking subsidiaries. While there were some limits on this authority, it does not appear that between passage of GLB and the financial crisis, the FRB ever exercised that authority. If it had, it might have noticed how undercapitalized the investment arms of bank holding companies were, and that, in turn, might have been a signal to the SEC to reconsider its own position on capital for those investment banks not owned by bank holding companies.

To be fair, many financial institutions involved in the same markets often failed to recognize the same risks. Moreover, especially for the larger financial institutions, more than one regulatory agency had overlapping jurisdiction, and none of them had clear authority. This fragmentation made it difficult for any agency or individual to understand the broader market holistically or to coordinate appropriate interagency communication to address growing problems.[121]

In other cases, issues originated outside of the regulatory umbrella. As noted above, independent mortgage originators not subject to federal regulation originated more than one-half of subprime loans in 2004 and 2005.[122] Here again, federal regulators were not in a good position to understand the full scope of what was taking place in markets they did not directly regulate. Inconsistent communication among state and federal regulators further contributed to the problem.

OTC Derivatives

Derivatives—financial transactions based on the value of an asset or other entity—have existed for hundreds of years. Farmers, for example, have hedged the value of their crops through futures markets. Many such transactions are executed in regulated markets, with futures trading on exchanges and insurance policies subject to numerous rules and regulations. And, the transactions involve assets or entities owned by the buyer of the derivative.

During the 1980s, 1990s, and 2000s, old rules that discouraged or prohibited speculative derivatives were gradually liberalized to allow their trade OTC (i.e., outside of regulated exchanges). An effort to bring such derivatives under the jurisdiction of the CFTC was explicitly blocked by the Commodity Futures Modernization Act of 2000. By one estimate, the value of the OTC derivatives market grew from its inception in the 1980s to about $24.7 trillion in mid-2012, while at the same time its credit risk equivalent was about $3.6 trillion.[123]

Substantial systemic risk was created by certain segments of this OTC derivatives market, notably those built on mortgage-based collateralized debt obligations and credit default swaps, which brought AIG to the brink of collapse before the federal government stepped in to save it. Few if any firms trading some of the more exotic derivatives had a full understanding of this market and its web of interconnections to other parts of the financial system and, because oversight of the OTC derivatives market was prohibited by statute, neither did regulators. Mortgage-based derivatives as a whole amplified the impact of the collapse of housing prices.

Oversight of Thrift Holding Companies

Prior to the savings and loan crisis of the 1980s, thrifts and thrift holding companies were overseen by the Federal Home Loan Bank Board. That crisis led to the creation of a new regulator for savings and loans and their holding companies, the OTS within the Treasury Department. When the OTS was created, however, Congress did not equalize the supervisory structure for savings and loan holding companies with the structure applicable to bank holding companies. Unlike bank holding companies, savings and loan holding companies were permitted to engage in a wider range of activities, including commercial activities and insurance. Moreover, savings and loan holding companies were not subject to fixed capital standards. This created an opportunity for "regulatory arbitrage" as some firms saw the acquisition of thrifts as a means to gain access to the federal safety net without facing the same activity constraints and costs associated with owning a bank and being regulated as a bank holding company by the Federal Reserve Board. For some of these holding companies, such as AIG, the thrift it owned was a small fraction of its overall business. A 2007 GAO report on improving coordination among the OTS, Federal Reserve, and SEC stated that while most firms overseen by the Federal Reserve and SEC were primarily engaged in banking and securities, respectively, "a substantial minority of the firms the OTS oversees—especially the large, complex ones—have primary businesses other than those traditionally engaged in by thrifts, such as insurance, securities, or commercial activities."[124]

As a relatively small agency that depended upon assessments for its operating funds, OTS also was subject to the potential for "regulatory capture" by larger thrifts. For example, a

February 26, 2009, audit report by the Treasury Department's Office of the Inspector General criticized the OTS's supervision of IndyMac Bank. The report said that OTS examiners did not look into IndyMac's controls to manage aggressive growth or loan underwriting; improperly allowed IndyMac to record a transfer payment as having been available earlier than it was to allow the thrift to report that it was well capitalized; and failed to take prompt corrective action to try to remedy the situation when it should have.[125] Earlier in the 2000s, the OTS and some of its examiners expressed concern with IndyMac's subprime lending, lax underwriting standards, and lack of adequate capital. However, the agency did not require that action be taken and, after the housing market had begun to collapse in 2007, the OTS said that the thrift's subprime lending was within its guidelines.[126] To one degree or another, the OTS also proved ineffective in its oversight of Washington Mutual, AIG, Countrywide, and others.

These three examples—the mortgage market and securitization, the regulation of OTC derivatives, and thrift holding company supervision—highlight the dangers of a fragmented regulatory system. Multiple and, at times, competing regulatory agencies can lead to poor communication, weakening of regulatory standards, overlapping and inefficient jurisdictions, and an inability to see the full picture of what is happening in markets. Further, these issues can be exacerbated when federal and state regulatory agencies do not coordinate their efforts and effectively communicate with one another.

In short, the fragmented structure of U.S. financial regulation was one of the several and varied causes of the financial crisis. This fragmentation manifested in a number of ways, including contributing to a system in which:

- No single entity was responsible for looking for problems in the overall financial system (i.e., there was no macro-prudential regulator);
- Systemically important portions of the shadow-banking system existed outside of the regulatory system, where many of the activities that led to the financial crisis originated. Many of these institutions had to be brought into the system during the crisis to prevent them from failing and causing significant collateral damage;
- Regulators were specifically prohibited from overseeing OTC derivatives market, which grew rapidly in the lead-up to the crisis;
- Multiple and sometimes overlapping supervisory teams made it more difficult for regulatory agencies to share relevant knowledge and expertise; and
- Some agencies were susceptible to regulatory capture due to lack of sufficient resources, the way they were funded, and the ability of financial institutions to switch charters led to regulatory arbitrage.

Appendix C: Recent Crisis-Related Proposals

This section contains a comparison of key provisions in the Dodd-Frank Act with how the issues those provisions were intended to address were handled by the Paulson Blueprint, the Geithner white paper, and RAFSA (Senate Banking Committee).

Dodd-Frank Reforms

The Dodd-Frank Act made a number of important changes to U.S. regulatory architecture, primary among them:

CREATION OF A FINANCIAL STABILITY REGULATOR

Each of the three major proposals agreed on the need for increased focus on the overall stability of the financial system. The Paulson Blueprint recommended that the Federal Reserve be given this responsibility with a revised mandate. The Geithner and Dodd frameworks both pushed for creation of a council of regulators to perform this role. This latter approach was eventually incorporated into the Dodd-Frank Act with the creation of the FSOC.

One of the FSOC's mandates is to identify and respond to risks to financial stability. Another is to promote information-sharing and coordination among the members of the Council. Membership includes the secretary of the Treasury, who chairs the FSOC; the heads of the CFPB, CFTC, FDIC, FRB, Federal Housing Finance Agency (FHFA), NCUA, OCC, and SEC; and an independent member with insurance expertise.

Providing support for the FSOC is the OFR. Housed at the Treasury Department, the OFR is responsible for conducting research to improve the quality of financial data available to policymakers, particularly for the purposes of analyzing financial system stability.

The Geithner white paper recommended authorizing the FSOC to collect information, while RAFSA specifically established the OFR for that purpose. The Paulson Blueprint did not address this issue.

CREATION OF A CONSUMER PROTECTION REGULATOR

The growth of systemic risk in the years leading up to the crisis came in part from toxic financial products like negative-amortization mortgages and so-called "liar loans" that originated to a significant extent outside of the safety-and-soundness focus of regulators.[127] In response, each of the three plans recommended the creation of a separate business conduct, or consumer protection, agency that would be responsible for identifying and monitoring such risk exposures in the economy.

The result was the creation by Dodd-Frank of the CFPB with a single director. An independent agency housed within the Federal Reserve, the Bureau took over consumer protection functions from pre-existing regulators, and was given an independent funding stream to carry out its mandate.

There has been a strong push since the passage of Dodd-Frank to modify the governance and funding of the CFPB. A group of 44 senators signed a letter to President Obama that supported subjecting the agency to congressional appropriations and replacing its single director with a bipartisan commission structure, much like the CFTC and SEC.[128] Advocates for a strong CFPB argued that such changes would neuter the agency's effectiveness. After a protracted debate the Senate eventually confirmed Richard Cordray to be the Bureau's director by a vote of 66-34 on July 16, 2013.[129]

TERMINATION OF THE OFFICE OF THRIFT SUPERVISION

Each of the three plans called for an end to the OTS, an agency widely criticized for the poor quality of its regulation leading up to the crisis. The Paulson Blueprint recommended transitioning the federal thrift charter to a national bank charter over two years, while the Geithner white paper and RAFSA recommended eliminating the charter altogether. Dodd-Frank merged most of the OTS into the OCC, but preserved the thrift charter. Some argue that the law removed much of the charter's appeal, so that it will fade away by itself over time.

ALTERING THE FEDERAL RESERVE'S POWERS

The FRB's authority was greatly expanded under Dodd-Frank. The FRB became the systemic risk regulator and now has regulatory control over all bank and non-bank SIFIs at the holding company level. While the FSOC has the authority to designate SIFIs, only the FRB is empowered to regulate them. The Federal Reserve also was given regulatory authority over all thrift holding companies, which were previously under the jurisdiction of the OTS. Their number includes many insurance companies that have thrift subsidiaries. In addition, the large investment banks and others like Goldman Sachs, Morgan Stanley, and American Express that became bank holding companies during the financial crisis are now under the FRB's authority as bank holding companies. As SIFIs they would remain under the FRB's authority even if they tried to "de-bank" and change their holding company status.

The Federal Reserve Board did pay some price for the emergency actions it took during the crisis. Although the task force believes the FRB's invocation of its emergency powers to an unprecedented degree helped to save the economy from a depression, many of its moves were nonetheless unpopular. Dodd-Frank placed several restrictions on regulators' future authority, including limiting emergency lending to programs and facilities with "broad based eligibility," and requiring greater transparency on the part of the FRB. And, as previously mentioned, the Act took away the FRB's consumer protection responsibilities and transferred them to the new CFPB. However, the Act placed the CFPB structurally within the Federal Reserve Board, although with a large degree of independence from it.

FEDERAL INSURANCE OVERSIGHT

A greater realization of the importance of systemic risk in the financial system led many to argue that the insurance industry must be monitored as part of the FSOC's mandate. In addition to including a member with insurance expertise on the FSOC, Dodd-Frank created the FIO, housed at the Treasury Department, to monitor all aspects of the insurance industry. While the agency does not have regulatory power, it helps identify gaps in regulation for the FSOC and assists in international negotiations on insurance matters.

Appendix D: Task Force and the Process for Writing the Report

THE REGULATORY ARCHITECTURE TASK FORCE

The co-chairs of the Regulatory Architecture Task Force are:

- **Richard H. Neiman**, Vice Chairman, Global Financial Services Regulatory Practice at PricewaterhouseCoopers, former New York Superintendent of Banks, and former member of the Troubled Asset Relief Program (TARP) Congressional Oversight Panel; and
- **Mark Olson**, Chairman of Treliant Risk Advisors, former Governor of the Federal Reserve Board, and former Chairman of the Public Company Accounting Oversight Board.

Special thanks to those connected with BPC's Financial Regulatory Reform Initiative who helped inform and guide us through this process, including: Co-Chairs **Martin Baily** and **Phillip Swagel**; BPC staff **Aaron Klein**, **Justin Schardin**, **Shaun Kern**, and **Peter Ryan**; and senior advisors **Jim Sivon**, partner with Barnett Sivon & Natter, PC, and **Greg Wilson**, Wilson Consulting.

BACKGROUND ON THE PROCESS FOR DEVELOPING THIS REPORT

The task force co-chairs developed its conclusions based on their extensive experience in state and federal regulation of financial institutions, as well as information-gathering sessions with a wide variety of public and private sectors experts, agencies, organizations, and individuals. The task force benefited greatly from these meetings, and the co-chairs are indebted to all who met with them. However, the co-chairs alone are responsible for the conclusions and recommendations in this report.

DISCUSSION QUESTIONS

To maintain a consistency of conversation, the task force used the document below as a starting point for discussion at the information-gathering meetings that it held.

Topic 1: Overall Regulatory Structure Post Dodd-Frank

Understanding that we can't approach questions of regulatory architecture from a blank slate, we'd like to start by discussing the current status of our regulatory structure, post-Dodd Frank. What do you think is and is not working in our current regulatory structure?

What, if any, positive changes did Dodd-Frank make to the regulatory structure?

What, if any, negative changes did Dodd-Frank make?

What, if any, gaps in regulatory architecture still exist post Dodd-Frank? What remedies are needed?

Part of Dodd-Frank was an attempt to fill gaps which were thought to exist in the regulatory structure, such as with AIG, the shadow-banking sector, or non-regulated consumer finance companies. However, in trying to fill these gaps some have suggested that the law created a regulatory structure that has significant amounts of overlapping authority. We'd like to discuss a few areas where there may be overlapping authority, but feel free to add others. For each one, do you think overlap exists, and if so, in what ways is it positive or negative?

- Among federal and state bank regulators?
- Between the CFPB, bank regulators, and federal and state enforcement agencies on consumer regulation and supervision?
- Between the SEC and CFTC?
- Between FSOC and its members?
- Between the Federal Reserve as systemic risk regulator and other regulators?
- Between OFR and financial regulators for data on systemic risk and the standardization of data across regulators going forward?
- Other?

We have a dual regulatory system for both banking and securities and a pure state-based system for insurance companies, although Dodd-Frank has potentially altered that for systemically designated companies. What steps, if any, do we need to take to ensure the proper balance and degree of coordination and cooperation between federal and state regulators for:

- Banking?
- Insurance?
- Securities?

One of Dodd-Frank's signature accomplishments was the creation of the Financial Stability Oversight Council (FSOC). After two years in existence, what is your view of the role the FSOC is playing to fulfill its mandate on financial stability, and how can it be improved?

- Do you agree with the decision to have the Treasury Secretary Chair FSOC?
- Do you think FSOC operates with the right degree of transparency?

- Is FSOC working to balance its financial stability responsibilities with the need to promote economic growth and innovation?
- Other thoughts on FSOC?

Topic 2: Changes to the Existing Structure

Assuming there is no fundamental overhaul of the U.S. regulatory architecture in the near term, what short-term steps should be taken to improve its effectiveness and the quality of regulatory outcomes?

- Which of those recommendations can be done without legislation?
- Which require legislation?

In the medium to longer-term, how can the U.S. financial regulatory architecture be improved to ensure greater effectiveness and better regulatory outcomes? Some specific ideas which have been suggested include:

- Merging the SEC and CFTC into one capital markets regulator
- Consolidating the federal bank regulators
    - If you favor this, would you keep the role of deposit insurance separate?
    - Would you also keep monetary policy separate?
    - Would there be a continued dual role of Federal Reserve and FDIC for annual resolution planning?
- Changes to the newly created CFPB?
- Other ideas?

Topic 3: Ways to Improve Regulatory Quality

For all the various financial regulatory agencies, do we have the proper balance of independence and accountability with respect to funding sources, governance, and desired outcomes? What works and what needs to be improved?

What needs to be done to ensure that regulatory skills and resources keep pace with industry skills and resources to maintain both quality supervision and a healthy financial system?

What can be done to ensure better coordination among international regulators and greater consistency of global standards and practices with domestic (i.e., U.S.) laws and regulations?

What steps can be taken, if any, to avoid unnecessary complexity, duplication, and regulatory gridlock?

The Government Accountability Office (GAO) has issued numerous reports on regulatory architecture, the most recent of which calls for more formal coordinating mechanisms among regulators, better cost-benefit analyses in line with OMB best practices, and greater use of alternative approaches to regulation. Do you agree with these findings?

- If so, how would you go about addressing them?
- If not, why?

Endnotes

[1] Macro-prudential regulation involves oversight geared toward ensuring the safety of the overall financial system, while micro-prudential regulation refers to supervision through monitoring the safety and soundness of individual financial institutions.

[2] Cheyenne Hopkins, "Reg Reform Bill Misses Opportunity to Overhaul Agencies," *American Banker*, May 21, 2010. Available at: http://www.americanbanker.com/issues/175_98/reg-reform-1019553-1.html and http://law.fordham.edu/faculty/19917.htm.

[3] The Department of the Treasury, "Blueprint for a Modernized Financial Regulatory Structure." March 2008. Available at: http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf.

[4] The Department of the Treasury, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation," June 17, 2009. Available at: http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

[5] Restoring American Financial Stability Act (S. 3217), 111th Congress, introduced April 15, 2010. This bill passed the Senate and was later integrated with House-passed legislation in conference to produce the Dodd-Frank Act.

[6] Michael Crapo, opening statement from "Examining the Fiscal Year 2012 Budget for the Securities and Exchange Commission," hearing before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, March 10, 2011. Available at: http://www.gpo.gov/fdsys/pkg/CHRG-112shrg66723/html/CHRG-112shrg66723.htm.

[7] Jerry W. Markham, "Merging the SEC and CFTC – A Clash of Cultures," Florida International University College of Law Legal Studies Research Paper No. 10-53, November 2010.

[8] House Committee on Financial Services, "Frank and Capuano Introduce Legislation to Merge the SEC and CFTC," press release, November 29, 2012.

[9] Ronald D. Orol, "Stars are lining up for merging SEC and CFTC," *The Wall Street Journal* Marketwatch, January 26, 2009. Available at: http://articles.marketwatch.com/2009-01-26/news/30800480_1_cftc-commodity-futures-trading-commission-futures-products.

[10] Markham, supra note 6.

[11] As one illustration, the Paulson Blueprint recommended that the SEC change its rules-based regulatory approach to a principles-based approach like the CFTC's.

[12] Din El Boghdady, "Proposed exchange merger brings renewed call to consolidate SEC and CFTC," *Washington Post*, December 21, 2012. Available at: http://articles.washingtonpost.com/2012-12-21/business/36017655_1_sec-and-cftc-exchange-merger-dodd-frank.

[13] Adriane Fresh and Martin Neil Baily, "What does international experience tell us about regulatory consolidation?" Pew Financial Reform Project, September 21, 2009. Available at: http://www.brookings.edu/~/media/Research/Files/Reports/2009/9/21%20consolidation%20baily/0921_consolidation_baily.PDF.

[14] Fresh and Baily, supra note 12.

[15] Treasury Blueprint, supra note 2, at 126-129.

[16] A New Foundation, supra note X,at 41-42.

[17] The National Insurance Act of 2007, S. 49, 110th Congress (2007).

[18] Treasury Blueprint, Ibid., p. 96.

[19] A New Foundation, Ibid., pp. 32-33.

[20] The voting members of the FSOC are the Treasury secretary; the heads of the CFPB, CFTC, FDIC, Federal Reserve Board, FHFA, NCUA, SEC; and an independent member with insurance experience. Non-voting members are the directors of the OFR and FIO, a state insurance commissioner, a state banking supervisor, and a state securities commissioner.

[21] Richard Fischer and Eric Rodriguez, "The Consumer Financial Protection Bureau: Measuring the Progress of a New Agency," The Bipartisan Policy Center, September 2013. Available at: http://bipartisanpolicy.org/library/report/consumer-financial-protection-bureau.

[22] Following the release of the BPC report, the CFPB announced it would no longer bring enforcement personnel to supervisory exams. See Alan Zibel, "Consumer Regulator to Stop Bringing Lawyers to Firm Exams," *The Wall Street Journal*, October 9, 2013. Available at: http://online.wsj.com/news/articles/SB10001424052702304520704579125930135610624.

[23] Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report," February 25, 2011, p. 54. Available at: http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[24] "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," U.S. Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, Majority and Minority Staff Report, April 13, 2011, p. 5. Available at: http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf?attempt=2.

[25] "Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc.," September 19, 2013. Available at: http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf. And: "Basis for the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.," July 8, 2013. Available at: http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20American%20International%20Group,%20Inc.pdf.

[26] 31 U.S.C. Section 313 (c).

[27] See generally Peter Ryan, "The Omnibus Spending Bill Highlights Contrasts in the Autonomy of Federal Regulators," Bipartisan Policy Center, January 22, 2014. Available at: http://bipartisanpolicy.org/blog/financialreform/2014/01/22/omnibus-spending-bill-highlights-contrasts-autonomy-financial-regulators.

[28] As opposed to regulation, which entails writing and enforcing rules, supervision involves on-site examinations of financial institutions.

[29] Basel Committee on Banking Supervision, "The relationship between banking supervisors and banks' external auditors," January 2002, p. 8. Available at: http://www.bis.org/publ/bcbs87.pdf.

[30] Thomas M. Hoenig, "Financial Oversight: It's Time to Improve Outcomes," remarks to the AICPA/SIFMA FSA National Conference, November 30, 2012.

[31] The CFPB conducts examinations on banks and credit unions, but only those with more than $10 billion in assets. See: 12 U.S.C. Section 5515 (a).

[32] Paulson Blueprint, Ibid., p. 99.

[33] Some federal agencies currently make training available to state supervisors. In 2012, for example, 458 instances of training across a variety of subjects was offered by the FFIEC through the FRB and FDIC with state sponsorship. This represented about 14 percent of the FFIEC's training slots for the year. See FFIEC Annual Report 2012, p. 9. Available at: http://www.ffiec.gov/PDF/annrpt12.pdf.

[34] The plan does not include the NCUA's examiners in its consolidation because of the significant differences in the business models of credit unions and banks and—since the consolidated examination force is contemplated as an interim step toward consolidation of the FDIC, FRB, and OCC—it would be inconsistent to bring the NCUA into the first stage of that transition.

[35] Information on FFIEC examiner education is available at: http://www.ffiec.gov/examiner.htm.

[36] For an analysis of some of the early successes and failures of the FFIEC, see Robert J. Lawrence, "Origin and Development of the Examination Council," February 1992, pp. 15-24, and the joint report of the Banking Agency Office of Inspector General of the Treasury Department, FDIC, and Federal Reserve, "Joint Evaluation of the Federal Financial Institutions Examination Council," June 21, 2002, pp. 10-15. Available at: http://www.fdicoig.gov/evaluations/02-003E.pdf.

[37] See, for example, the FFIEC policy statement on prudent commercial real estate loan workouts. Available at: https://www.ffiec.gov/press/pr103009.htm.

[38] The IT Examination HandBook InfoBase is available at: http://ithandbook.ffiec.gov/.

[39] Figures are rounded to the nearest thousand dollars.

[40] 12 U.S.C. Section 1833b.

[41] BPC did not receive data from the Federal Reserve Board or the Federal Reserve Bank of Richmond. Comparing data among the Reserve Banks is difficult since each has different titles for its examiners. Therefore, any attempt at grouping the data in this table into consistent job categories requires subjective judgments. Figures are rounded to the nearest thousand dollars.

[42] See, for example, "An International Review of OCC's Supervision of Large and Midsize Institutions: Recommendations to Improve Supervisory Effectiveness," December 4, 2013, p. 1. Available at: http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-184a.pdf.

[43] The Bureau of Labor Statistics projected job growth for financial examiners of 27% from 2010-2020, a faster than average pace. See: http://www.bls.gov/ooh/business-and-financial/financial-examiners.htm.

[44] The FFIEC should also encourage and work with states to create slots for degree-holders.

[45] Rose Marie Kushmeider, "The U.S. Financial Regulatory System: Restructuring Federal Bank Regulation," *FDIC Banking Review*, 2005, Vol. 17, No. 4, pp. 25-9. Available at: http://www.fdic.gov/bank/analytical/banking/2006jan/article1/article1.pdf.

[46] A description of the OCC's 2013 fee structure is available at: http://www.occ.gov/news-issuances/bulletins/2012/bulletin-2012-40.html.

[47] Macro-prudential regulation refers to oversight of the financial system as a whole, while micro-prudential regulation refers to the safety and soundness of individual financial institutions.

[48] See: John F. Bovenzi, Randall D. Guynn, and Thomas H. Jackson, "Too Big to Fail: The Path to a Solution," Bipartisan Policy Center, May 2013. Available at: http://bipartisanpolicy.org/sites/default/files/TooBigToFail.pdf.

[49] The FIO's authority includes recommending the designation of insurers as SIFIs, to coordinate federal efforts to develop federal policy on prudential insurance policy, and representing the United States in the International Association of Insurance Supervisors. A full list of authorities can be found in 31 U.S.C. Section 313 (c).

[50] For example, the Federal Reserve is responsible for setting capital and other heightened prudential standards for SIFI insurance companies.

[51] Financial Stability Board, "Peer Review of the United States," August 27, 2013, pp. 36. Available at: http://www.financialstabilityboard.org/publications/r_130827.pdf.

[52] Ibid.

[53] Governor Daniel Tarullo, Memo to the Board of Governors of the Federal Reserve System, "Final rules to implement the enhanced prudential standards of section 165 of the Dodd-Frank Act," p. 22. Available at: http://www.federalreserve.gov/aboutthefed/boardmeetings/memo_20140218.pdf.

[54] See: Aaron Klein, statement to the Subcommittee on Financial Institutions and Consumer Protection of the Senate Committee on Banking, Housing and Urban Development, "Finding the Right Capital Regulations for Insurers," Hearing, March 11, 2014. Available at: http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=b08b03f0-5f62-4faf-820c-be9e9967fd7d.

[55] Federal Insurance Office, U.S. Department of the Treasury, "How to Modernize and Improve the System of Insurance Regulation in the United States," December 2013, p. 63. Available at: http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/How%20to%20Modernize%20and%20Improve%20the%20System%20of%20Insurance%20Regulation%20in%20the%20United%20States.pdf.

[56] Ibid. pp. 63, 65

[57] Jim Sivon, "The Status of the Federal Thrift Charter Post-Dodd-Frank," Barnett Sivon & Natter, *Our Views*, August 2011. Available at: http://www.bsnlawfirm.com/newsletter/OP0811_4.pdf.

[58] Ibid.

[59] FSOC, "Financial Stability Oversight Council Makes First Nonbank Financial Company Designations to Address Potential Threats to Financial Stability," July 9, 2013. Available at: http://www.treasury.gov/press-center/press-releases/Pages/jl2004.aspx.

[60] FSOC, "Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc.," September 19, 2013. Available at: http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf. Prudential lost its appeal to the FSOC of its SIFI designation, and later decided not to pursue court action to overturn it. See Sarah N. Lynch, "Prudential says it will not appeal U.S. council's systemic tag," Reuters, October 18, 2013. Available at: http://www.reuters.com/article/2013/10/18/us-prudential-fsoc-idUSBRE99H11620131018.

[61] FSOC, "Proposed Recommendations Regarding Money Market Mutual Fund Reform," November 2012. Available at: http://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%2013,%202012.pdf.

[62] The Volcker Rule's regulations, assigned to five different agencies, took more than three years to be finalized, and there have been well-publicized clashes between agencies, such as between the SEC and CFTC on cross-border swap issues. See for example: Victoria McGrane and Scott Patterson, "Regulators Clash Over Volcker Definitions," *The Wall Street Journal*, October 22, 2012. Available at: http://online.wsj.com/news/articles/SB10001424052970203400604578072824053423376.

[63] 12 U.S.C. Section 5513 (c) (3) (A). The FSOC may issue a stay of, or set aside, a CFPB regulation by a 2/3 vote of members then serving.

[64] The FSOC proposed three alternatives for money market mutual funds: a floating net asset value (NAV), a stable NAV and NAV buffer and "minimum balance at risk," and a stable NAV and NAV buffer with other measures. See http://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%2013,%202012.pdf.

[65] Public Law 111-203, 124 Stat. 1408-1410, July 21, 2010. Available at: http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

[66] The five agencies were the CFTC, FDIC, FRB, OCC, and SEC.

[67] 12 U.S.C. Section 1851 (b) (2) (A).

[68] 12 U.S.C. Section 1851 (c) (1).

[69] See: Martin Baily, John Coffee, Jim Cox, Annette Nazareth, Jonathan Macey, and Phillip Swagel, letter to Tim Geithner, Thomas Curry, Ben Bernanke, Martin Gruenberg, Elisse Walter, and Gary Gensler, December 20, 2012. Available at: http://bipartisanpolicy.org/sites/default/files/Volcker%20Letter%20Final_0.pdf.

[70] Public Law 111-203, 124 Stat. 1395, July 21, 2010.

[71] Ibid., 124 Stat. 1408.

[72] In an approval vote is one in which voters may "approve" as many voting options as they would like, and the one that receives the most votes is declared the winner. In this case, tie votes among members of the FSOC would be broken by the vote of the FSOC chair.

[73] According to data at the National Information Center of the Federal Reserve System, 13 U.S. bank holding companies held assets of greater than $250 billion as of December 31, 2013. Available at: http://www.ffiec.gov/nicpubweb/nicweb/top50form.aspx. The characteristics the FSOC considers when deciding whether to designate non-bank financial institutions as SIFIs includes size, interconnectedness, substitutability, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. Such factors apply well when assessing the systemic risk posed by banks as well. For a review of the FSOC's process for non-bank designation process, see for example: Arnold & Porter LLP, "FSOC Issues Final Rule for Making 'Systemically Important' Designations," April 2012. Available at: http://www.arnoldporter.com/resources/documents/Advisory%20FSOC_Issues_Final_Rule_for_Making_Systemically_Important_Designations.pdf.

[74] Implicit support for a new threshold level may be found in the proposed rules implementing the Basel Committee's liquidity coverage ratio framework released by the Federal Reserve Board on October 24, 2013. The rules propose to apply to internationally active banking organizations with $250 billion or more in consolidated assets or $10 billion or more in on-balance sheet foreign exposure. Bank holding companies or thrift holding companies that did not have significant insurance or commercial operations would be subject to a less stringent set of rules. See: http://www.federalreserve.gov/newsevents/press/bcreg/20131024a.htm.

[75] 12 CFR Part 1310, p. 15. Available at: http://www.treasury.gov/initiatives/fsoc/documents/nonbank%20designations%20-%20final%20rule%20and%20guidance.pdf. Since the task force's plan recommends a consolidated prudential regulator, the sixth factor used by the FSOC in reviewing potential non-bank SIFI designations—existing regulatory scrutiny—would not be relevant to bank SIFI designation decisions.

[76] See U.S. Government Accountability Office, "Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions," September 2012. Available at: http://www.gao.gov/assets/650/648064.pdf.

[77] Financial Stability Oversight Council, "Dodd-Frank Wall Street Reform and Consumer Protection Act Integrated Implementation Roadmap," October 1, 2010, slide 7. Available at: http://www.treasury.gov/initiatives/Documents/FSOC%20Integrated%20Roadmap%20-%20October%201.pdf.

[78] Organization chart for the U.S. Department of the Treasury's Office of Domestic Finance, as of December 12, 2012. Available at: http://www.treasury.gov/about/organizational-structure/offices/Documents/Domestic%20Finance%20Org%20Chart.pdf.

[79] The OFR's director's congressional testimony, for example, does not need to be submitted for approval to like other offices within executive branch departments. See: 12 U.S.C. Section 5343 (d).

[80] U.S.C. 12 Section 5345 (d).

[81] Portions of the text for this recommendation are drawn from a speech given by Richard H. Neiman, one of the co-authors of this report, at the Levy Economics Institute of Bard College to the 19th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies, on April 14, 2010. Available at: http://www.dfs.ny.gov/about/speeches/sp100414.htm. An editorial by Mr. Neiman with a similar theme also appeared in the *American Banker* on March 23, 2010, link unavailable.

[82] Paulson Blueprint, Ibid., p. 106.

[83] The NCUA, which supervises federal and federally insured credit unions, is not shown here since the task force is not recommending any changes to its current supervisory responsibilities.

The Consumer Financial Protection Bureau (CFPB), which regulates consumer financial products, is not included here since it is not a prudential regulator.

"State Supervisors" in this figure refers to banking, insurance, and investment supervisors in the individual states. Each state differs in its allocation of responsibility to its financial regulators.

Bank holding companies with total consolidated assets of $50 billion or more, and designated non-bank financial companies, must submit resolution plans to the Federal Reserve Board and the FDIC. As a result, the FDIC is depicted here as having both micro- and macro-supervisory roles.

The OFR is displayed as a subsidiary of the FSOC under the current system, reflecting the fact that a) its director reports to the chairman of the Council, and b) the OFR's principal function is to provide research to the FSOC. By contrast, the OFR is represented as separate entity under the task force proposal, reflecting its recommendation that the OFR be made fully independent of the Department of the Treasury.

[84] The NCUA, which supervises federal and federally insured credit unions, is not shown here since the task force is not recommending any changes to its current supervisory responsibilities.

Investment and securities products are also regulated by state supervisors. These supervisors are not displayed in this figure.

[85] Commodity Futures Trading Commission, FY 2014 President's Budget and Performance Plan, p. 2. Available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2014.pdf.

[86] U.S. Securities and Exchange Commission, FY 2014 Congressional Budget Justification,

[87] Joe Morris, "US regulators 'funded at a level to fail,'" *Financial Times*, January 19, 2014. Available at: http://www.ft.com/intl/cms/s/0/ee99cec0-7f15-11e3-8642-00144feabdc0.html?siteedition=intl#axzz2r9CuENDg&_cldee=anNjaGFyZGluQGJpcGFydGlzYW5wb2xpY3kub3Jn.

[88] Peter Ryan, Ibid."The Omnibus Spending Bill Highlights Contrasts in the Autonomy of Federal Regulators," Bipartisan Policy Center, January 22, 2014. Available at: http://bipartisanpolicy.org/blog/financialreform/2014/01/22/omnibus-spending-bill-highlights-contrasts-autonomy-financial-regulators.

[89] Lynch, Sarah N., "Wall Street regulators face budget crunch under new spending deal," *Reuters*, January 14, 2014.

[90] Peter Ryan, supra note 79.

[91] Born, Brooksley and William Donaldson, "Self-funding of regulators would help fiscal mess," *Politico*, March 10, 2013. Available at: http://www.politico.com/story/2013/03/self-funding-of-regulators-would-help-fiscal-mess-88666.html.

[92] SEC Chairman Mary Schapiro, Letter to Senate Minority Leader Mitch McConnell, April 15, 2010. Available at: http://www.sec.gov/news/speech/2010/spch041510mls-mcconnell-letter.pdf.

[93] CFTC, Testimony of Chairman Gary Gensler before the US House Appropriations Subcommittee, April 12, 2013. Available at: http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-139.

[94] SEC, Testimony on "Wall Street Reform: Oversight of Financial Stability and Customer and Investor Protections," February 14, 2013. Available at: http://www.sec.gov/news/testimony/2013/ts021413ebw.htm.

[95] Andrew Ackerman, Budget Seeks CFTC User Fee, More Funds for Regulators," *The Wall Street Journal*, February 13, 2012. Available at: http://online.wsj.com/article/SB10001424052970204883304577221100617958514.html.

[96] Michael Barnier, letter to Federal Reserve Board Chairman Ben Bernanke, April 18, 2014. Available at: http://www.federalreserve.gov/SECRS/2013/April/20130422/R-1438/R-1438_041913_111076_515131431183_1.pdf.

[97] Katia D'Hulster and Inci Otker-Rober, "Ring-fencing Cross-Border Banks: An Effective Supervisory Response?" Internatioanl Monetary Fund – Monetary and Capital Markets Department and World Bank; January 24, 2014, p. 1. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2384687.

[98] Financial Stability Board, "OTC Derivatives Market Reforms: Sixth Progress Report on Implementation," September 2, 2013, pp. 5-6. Available at: https://www.financialstabilityboard.org/publications/r_130902b.pdf.

[99] Ibid., p. 6.

[100] 12 U.S.C. Section 1812 (a) (1).

[101] 12 U.S.C. Section 1812 (a) (1) (C).

[102] See, e.g., Treasury Blueprint, Ibid.

[103] Federal Reserve Bank of Philadelphia, "The Second Bank of the United States. A Chapter in the History of Central Banking." Available at: http://www.philadelphiafed.org/publications/economic-education/second-bank.pdf.

[104] Ben Bernanke. (2000). *Essays on the Great Depression.* Princeton, NJ: Princeton University Press.

[105] Four notable sections of the Act—sections 16, 20, 21, and 32—required the separation of commercial and investment banking activities. Some of these sections remain in place today, though much attention is given to the Gramm-Leach-Bliley Act's repeal of sections 20 and 32. Section 20 allowed banks to affiliate with organizations

"engaged principally" in underwriting securities, while the repeal of Section 32 enabled commercial banks and investment banks to share board directors, officers, and employees. However, these repeals did little other than codify where courts, regulators, and market participants had already gone. For example, the merger of Citicorp and Travelers Group was essentially approved by federal regulators before Gramm-Leach-Bliley was enacted. In September 23, 1998, the Federal Reserve approved Travelers Group Inc.'s application to become a bank holding company by acquiring Citicorp. The Gramm-Leach Bliley Act was signed by President Bill Clinton on November 12, 1999. Though the merger of Travelers and Citicorp was approved, the Bank Holding Company Act still required the merged entity to divest impermissible business lines within two years, with the Federal Reserve Board having the to extend the conformance period to no more than five years. It was widely expected at the time that the Federal Reserve would have extended this conformance period to the maximum five years. The Federal Reserve's actions placed further pressure on Congress to consider reforms that ultimately were incorporated into Gramm-Leach-Bliley. For a more thorough analysis from the time, see http://www.stblaw.com/google_file.cfm?TrackedFile=4B46116306DFF48682B3&TrackedFolder=585C1D235281AED996A07D5F9F9478AB5A90188899.

106 Saule T. Omarova and Margaret E. Tahyar. (2011) "That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States." Page 25. Available at: http://www.bu.edu/law/central/jd/organizations/journals/banking/archives/documents/volume31/BankHoldingCoRegulation.pdf.

107 Commodity Futures Trading Commission, "Mission & Responsibilities." Available at: http://www.cftc.gov/About/MissionResponsibilities/index.htm.

108 For an overview of these two laws, see FDIC Public Information Center, "History of the Eighties—Lessons for the Future," Volume I, pp. 100-5. Available at: http://www.fdic.gov/bank/historical/history/87_136.pdf.

109 Federal Deposit Insurance Corporation, "History of the Eighties—Lessons for the Future." Chapter 7. Available at: http://www.fdic.gov/bank/historical/history/235_258.pdf.

110 Jith Jayaratne and Philip E. Strahan, "The Benefits of Banking Deregulation" FRBNY Economic Policy Review. December 1997. Available at: http://www.nyfedeconomists.org/research/epr/97v03n4/9712jaya.pdf.

111 Senate Permanent Subcommittee on Investigations Report, "Wall Street and the Financial Crisis: Anatomy of a Financial Crisis" April 13, 2011. Page 15. Available at: http://www.levin.senate.gov/imo/media/doc/supporting/2011/PSI_WallStreetCrisis_041311.pdf.

112 The Financial Services Modernization Act of 1999, Pub. L. 106-102.

113 Conference of State Banking Supervisors, Banking Law 101, Gramm-Leach Bliley Act of 1999. Available at: http://www.csbs.org/bankinglaw101/Wiki%20Pages/Gramm-Leach-Bliley%20Act%20of%201999.aspx.

114 Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, and Hayley Boesky, "Shadow Banking," Federal Reserve Bank of New York, Retrieved September 16, 2013. Available at: http://www.newyorkfed.org/research/epr/2013/0713adri.pdf.

115 Martin Neil Baily, Robert E. Litan, and Matthew S. Johnson, "The Origins of the Financial Crisis," Brookings Initiative on Business and Public Policy, November 2008, p. 14. Available at: http://www.brookings.edu/~/media/research/files/papers/2008/11/origin%20crisis%20baily%20litan/11_origins_crisis_baily_litan.pdf.

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117 Ibid, p. 41.

118 Ben S. Bernanke, "Semiannual Monetary Policy Report to Congress" before the Committee on Financial Services, U.S. House of Representatives, July 18, 2007. Available at: http://www.federalreserve.gov/newsevents/testimony/bernanke20070718a.htm.

119 Matthew Goldstein, "The Amazing Shrinking Pile of Non-Agency Mortgage Debt," Reuters, March 8, 2013. Available at: http://blogs.reuters.com/unstructuredfinance/2013/03/08/the-amazing-shrinking-pile-of-non-agency-mortgage-debt/.

120 Baily, Litan, and Johnson, Ibid., p. 40.

121 Ibid.,p. 41.

122 Ibid.

123 Bank for International Settlements, "Statistical release: OTC derivatives statistics at end-December 2012," May 2013. Available at: http://www.bis.org/publ/otc_hy1305.pdf. The market value is the cost of replacing extant OTC derivatives contracts, while the credit risk equivalent accounts for "netting" of contracts that cancel each other out.

124 "Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration," US Government Accountability Office, March 2007, p. 5. Available at: http://www.gao.gov/assets/260/257558.pdf.

125 "Safety and Soundness: Material Loss Review of IndyMac Bank, FSB," Office of the Inspector General, Department of the Treasury, February 26, 2009, pp. 15-16. Available at: http://www.treasury.gov/about/organizational-structure/ig/Documents/oig09032.pdf.

[126] Ibid., pp. 18-22.

[127] Negative amortization loans are those in which monthly payments are not enough to cover the loan's interest, leading to an increase in the amount of principle owed on the loan. A liar loan is a mortgage loan in which the income and asset claims of the borrower are not verified by the lender or mortgage originator. The market for these and other risky mortgage products were cases of bad underwriting that relied on ever-rising home prices to avoid collapse.

[128] Senator Richard Shelby, "44 US Sens. to Obama: No Accountability, No Confirmation," letter and press release, May 5, 2011. Available at: http://www.shelby.senate.gov/public/index.cfm/newsreleases?ContentRecord_id=893bc8b0-2e73-4555-8441-d51e0ccd1d17.

[129] U.S. Senate roll call vote record, 113th Congress, 1st Session, Vote Number 174. Available at: http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=113&session=1&vote=00174.

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