Choosing Financial Regulatory Agency Mandates

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This note discusses how U.S. legislators can address the difficult problem of choosing between different ways of dividing up the responsibilities of federal financial regulatory agencies.

The analysis suggests that:

- regulation by objective is an attractive approach for the United States going forward;
- if, as seems likely, no "pure" approach will actually be adopted, then the eleven principles applied here can act as a useful checklist for spotting places where ongoing inter-agency cooperation and Congressional scrutiny should perhaps be especially intense.

The note is divided into four sections:

- the first looks at four different approaches that have been widely discussed and advocated as ways of achieving completeness, consistency and efficiency;
- the second enumerates eleven principles that could be used to gauge whether specific divisions of responsibility between agencies are sound or not;
- the third uses the principles to evaluate the four approaches; and
- the final section concludes with some examples of how these principles can be applied usefully when political constraints are taken into account.

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1. Different Approaches

Four general approaches have been discussed and adopted in different countries in the past fifteen years: [2]

a) Institutional regulation which divides up mandates amongst agencies according to institutional type. Today, the mandate for several Federal financial agencies correspond to this principle inasmuch as investment banks, state banks, national banks, bank holding companies, thrifts, GSEs, and insurance companies all have separate lead regulators. China, Hong Kong and Mexico cleave to this approach.

b) Functional regulation which divides up mandates according to activities – such as banking, securities trading, futures trading, insurance activities and so on. Likewise, there are elements of functional regulation of this approach in our current federal financial regulatory regime, in for example the split between the SEC for securities trading and the banking agencies for banking activities. Brazil, France, Italy and Spain have applied functional regulation in different ways.

c) Regulation by objective whereby different regulators take responsibility for different objectives, such as systemic stability, institutional safety and soundness, consumer protection and other aspects of the conduct of business, like transparency, fair market practices and disclosure. Twin Peaks is a sub-category of this approach where all of prudential regulation comes under one regulator and all of conduct-of-business regulation comes under another. Australia and the Netherlands have adopted this approach. The Paulson Blueprint advocated a version of regulation by objective.[3]

d) Integrated approach whereby all financial regulation is concentrated in a single agency. Canada, Germany, Japan and the UK provide examples.

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[2] For an excellent reference work on how other countries divide up mandates, see the Group of Thirty volume published last year: "The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace." http://www.group30.org/pubs/GRP30_FRS_ExecSumm.pdf.

[3] The Paulson Blueprint (http://www.treas.gov/press/releases/reports/Blueprint.pdf) is properly known as "The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure", US Treasury, March 2008.

2. Principles

Ideally, mandates should be divided up to:[4]

Achieve good coverage:

1. Avoid overlapping responsibilities and duplicated burdens on the industry and consumers
2. Achieve complete coverage of institutions, products, processes and markets

Promote good management:

3. Result in effective concentration of expertise
4. Facilitate development of strong fit-for-purpose agency cultures
5. Establish clear accountability within agencies, and between agencies and Congress
6. Provide sufficient independence from future political pressures
7. Avoid undue concentration of power
8. Minimize the risk of regulatory capture
9. Require and incent effective inter-agency cooperation

Accommodate change:

10. Accommodate desirable evolution of the system over the long run in response to the needs of US households and businesses
11. Work well in normal times, when the system is at risk and when it is in crisis.

One more principle is often cited for leaving things as they are: the desirability of competition amongst agencies to give industry a choice and, by implication, to reduce costs and ultimately improve services for consumers. I have not included it here for three reasons:

- recent experience has been discouraging: OTS was created in large measure to provide such competition amongst federal charters; it lowered its standards to attract institutions; WAMU, AIG and Indi Mac took advantage of these; and taxpayers paid the price;

[4] The GAO report, "Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System" (GAO-09-216, January 8, 2009) sets out nine criteria that are broader and less specific than the principles annunciated here. The GAO criteria are meant for analyzing every aspect of regulatory reform including, for example, minimizing taxpayer exposure and do not focus on dividing up agency mandates. http://www.gao.gov/new.items/d09216.pdf.

- long term, there is plenty of competition anyway from the states and from regulators in other countries; and
- while application of the eleven principles does involve judgment about trade-offs, adding "competition" as a principle would make the problem worse since it would mitigate against three other principles – (1), (3) and (8).

Obviously, the eleven principles enumerated here can all be qualified, expanded and explained in some detail, the idea behind each of them is generally pretty clear. One exception is Principle 9 on cooperation and it is worth saying a bit more about it here. Weak leadership or working level cooperation can undo any division of mandates.

This is a difficult problem which current proposals do not address well. So it may be worth considering more radical options:

- Requiring every federal financial regulatory agency by statute to help every other federal financial regulatory agency fulfill its principle mandates.
- Mandating open availability of all data and information amongst agencies – perhaps managed centrally.
- Requiring all senior civil servant performance evaluations to be conducted with other agency representation and in such a way that evidence of cooperation across agency lines weighs heavily in compensation and promotion decisions.

3. <u>Evaluating the Approaches</u>

Chart 1 shows how the four approaches (when implemented as well as possible) compare using these eleven criteria:

- all four approaches score well on most criteria;
- institutional and functional regulation share a critical disadvantage: as new forms of institution and new activities emerge, gaps can open up. There is no guarantee they will be comprehensive in the future, even if they are now;
- the integrated approach does not suffer from this shortcoming, but it involves a degree of concentration of power that is likely to be unacceptable to US policymakers; and
- that leaves regulation by objective as the only one of these four "pure" approaches that scores well on all eleven criteria. Congress could enact regulation by objectives and leave it alone. The financial system could then be free to create new products, activities and organizational structures without the necessity of redrawing the boundaries between agencies every few

years. Whether a vision can be realized of a financial system as fair, stable and competitive will depend on how well individual agencies meet their mandates (among other things), but the approach could support all three of these fundamental goals.

Chart 1: Regulation by objective leads other approaches – but not by much

		Institutional regulation	Functional regulation	Regulation by objective	Integrated approach
Achieve good coverage:					
1	Avoid overlaps	Yes	Yes	Yes	Yes
2	Complete coverage			Yes	Yes
Promote good management:					
3	Concentrate expertise	Yes	Yes	Yes	Yes
4	Fit-for-purpose cultures	Yes	Yes	Yes	Yes
5	Clear accountability	Yes	Yes	Yes	Yes
6	Independence	Yes	Yes	Yes	Yes
7	No undue concentration of power	Yes	Yes	Yes	
8	Minimal regulatory capture	Yes	Yes	Yes	Yes
9	Effective inter-agency cooperation	Yes	Yes	Yes	Yes
Accommodate change:					
10	Accommodate desirable evolution			Yes	Yes
11	Work well in all circumstances	Yes	Yes	Yes	Yes

It may not be obvious that regulation by objective can satisfy principle (1). Chart 2 suggests that this is possible.

Chart 2: How regulation by objective might avoid overlaps

	Systemic risk regulator	Conduct of business regulator	Prudential regulator	Central bank
Determining the state of the system	Yes			
Normal times				
Examination and supervision of financial institutions (fis)			Yes	
Accounting standard setting		Yes		
Setting and enforcing rules on disclosure		Yes		
Setting and enforcing rules on market manipulation		Yes		
Setting and enforcing standards of risk management			Yes	
Setting and enforcing micro-prudential capital standards			Yes	
Setting and enforcing governance standards in fis			Yes	
Distributing information among agencies	Yes			
Collecting and managing deposit insurance			Yes	
Collecting and managing systemic insurance	Yes			
Managing resolutions			Yes	
At-risk times				
Jawboning institutions and markets	Yes			
Adjusting leverage levels and systemic insurance premia	Yes			
Managing resolutions			Yes	
In crisis				
Supporting market liquidity				Yes
Supporting institutional liquidity				Yes
Coordinating resolutions	Yes			

4. Applying the Ideas

How applicable are these ideas in reality?

The current Administration proposal does use regulation by objective for its table of contents. The approach does inform and structure their proposal to a degree, even though it remains a variation on the hybrid approach of the past.[5]

Political and historical constraints or other considerations may very well prevent complete adoption of any one approach. Still, *the principles can act as a checklist for any division of mandates. Where any principle is violated, there will usually be need for closer ongoing oversight and more inter-agency cooperation:*

- leaving the CFTC and SEC separate will strain principles (1), (2), (3) and (10). Harmonization of their differences and drawing clear lines between their authorities will inevitably be ongoing projects;
- continued balkanization of agencies scores poorly on (1), (3), (5), (8), (10) and (11): if the Fed, a successor to OCC and OTS, the FDIC and the SEC all continue to examine institutions, for example, consistency and completeness of examinations will continue to be difficult and expensive to achieve; and
- if FHFA and the Fed supervise small groups of institutions going forward, ongoing Congressional attention will be needed to ensure that the interests and patterns of thought of each agency and its charges do not become too closely aligned over time (Principle (8)).

[5] US Treasury, June 2009: "Financial Regulatory Reform: A New Foundation" http://www.financialstability.gov/docs/regs/FinalReport_web.pdf