

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is centered in the narrow neck of the hourglass. The text is centered within the hourglass.

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*Federal Financial Services Regulatory Consolidation: An  
Overview*

Walter W. Eubanks, Government and Finance Division

July 10, 2008

**Abstract.** This report is an overview of the U.S. federal financial services regulatory structure. It provides an historical analysis of the current U.S. functional and competitive regulatory structure. It discusses some of the recent proposals to consolidate the U.S. regulatory agencies, and it assesses three consolidated financial services regulatory structures abroad.

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# CRS Report for Congress

## Federal Financial Services Regulatory Consolidation: An Overview

Updated July 10, 2008

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Prepared for Members and  
Committees of Congress

# Federal Financial Services Regulatory Consolidation: An Overview

## Summary

Among the arguments offered for consolidating the federal regulatory structure of the financial services industry is that the industry has changed in ways that blur the clear-cut boundaries between the functional areas of banking, insurance, securities, and commodities markets. It has also been argued that while the financial services firms are primarily responsible for effectively managing their risks, the new nature of those risks has created a need for the government to take a more comprehensive approach to financial regulation. Moreover, a consolidated financial services regulator at the national level is more suited to accommodate international regulatory negotiations on financial services regulations such as capital, accounting, and privacy standards. The most recent proposal to consolidate the federal regulatory structure is the *Department of the Treasury Blueprint for a Modernized Regulatory Structure* (page 13), which would merge several federal regulatory agencies' functions into five distinct functional supervisory agencies. The proposal consolidates regulatory functions, not agencies.

Even though a number of proposals to consolidate the federal regulatory structure of the financial services industry have been put forth, the United States has yet to make any significant move to do so. A key reason is that the functional, competitive regulatory structure of the United States was, and continues to be, viewed by most policymakers and knowledgeable observers as being sound over time, despite a number of crises. For example, significant federal regulation of banks first occurred during the Civil War when states' management of their currencies failed dramatically. In another example, financial regulators addressed the savings and loan associations failures of the 1980s with risk-based capital requirements for all insured-depository institutions for the first time. The Sarbanes-Oxley Act established accounting standards for publicly traded companies in response to the accounting frauds leading to the bankruptcy of several large publicly traded firms. The structure has often been able to successfully address such problems quickly before they disrupt the economy.

To improve their ability to regulate the modern financial services sectors, many countries including the United Kingdom, Japan, and Germany have recently consolidated their financial services regulatory agencies. Financial Services Authority of the United Kingdom (FSA-UK), the Financial Services Agency of Japan (FSA- Japan), and the Federal Financial Supervisory Authority (BaFin) in Germany provide a point of comparison for the U.S. regulatory structure. These foreign regulatory structures are said to offer more effective methods of regulating modern financial services firms.

This report is a brief overview of the U.S. federal financial services regulatory structure. It briefly provides an historical analysis of the current U.S. functional and competitive regulatory structure. It discusses some of the recent proposals to consolidate the U.S. regulatory agencies, and it assesses three consolidated financial services regulatory structures abroad.

This report will be updated as developments warrant.

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# Federal Financial Services Regulatory Consolidation: An Overview

## Introduction

Today, financial services, banking, insurance and securities trading are no longer specific to an institution, but are delivered by almost every financial services institution in most cases with little or no differentiation. Since the 1980s, financial services companies increasingly commingle products and services. The passage of P.L. 106-102, the Gramm-Leach-Bliley Act (GLBA), incorporated the commingling of financial services within institutions into U.S. financial services law. In this new GLBA framework, the responsibilities of regulating financial institutions are more difficult to achieve because their business activities have become more interrelated.

Technological advances have helped to erase the traditional lines of demarcation in financial services products upon which the regulatory structure was built. Bank regulators, for example, continue to lower barriers to bank entry into commodity futures and the options business, and insurance has become a popular bank product. As bankers get more involved in the securities business, the business has been changing rapidly. As financial instruments or products become more complicated, the riskiness (probability of default) of the products is more difficult to determine for regulatory purposes. Maintaining a regulatory structure and control based on past market demarcations that are now slowly disappearing raises questions about the effectiveness of the regulatory structure that has responsibility for the safety and soundness of the financial institutions under its jurisdiction.

This report is a brief overview of the U.S. federal financial services regulatory structure. The first section is a brief historical analysis of the functional and competitive regulatory structure of the three major financial services — banking, insurance, and securities, including commodities futures and options. The second section deals with the difficulties in regulating institutions when they begin to provide services outside their demarcated lines of business. The third section discusses some of the recent proposals to consolidate regulatory agencies in the United States. The fourth section briefly assesses the consolidated financial services regulatory structures in the United Kingdom, Japan, and Germany, and the report concludes with some implications.

## The Major Financial Services Regulators

There are currently seven major federal regulators for the financial services industry. The following is a summary of the supervisory duties of the Office of the Comptroller of the Currency (OCC), the Federal Reserve System (the Fed), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision

(OTS), the National Credit Union Administration (NCUA), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC). All these agencies regulate for safety and soundness. The SEC and the CFTC emphasize consumer protection more than the others.

- **The Office of the Comptroller of the Currency (OCC).** The OCC is the regulator for just under 2,000 nationally chartered banks, and the U.S. branches and offices of foreign banks. The OCC conducts on-site examinations of each national bank at least three times within every two-year period.
- **The Federal Reserve System (Fed).** The Fed supervises about 950 state-chartered commercial banks that are members of the system and more than 5,000 bank holding companies and financial holding companies. Along with the OCC, it also supervises some international activities of national banks. The Fed uses both on-site examination and off-site surveillance and monitoring in its supervision process. Each institution is examined on-site every 12 to 18 months. The Fed's in-house examiners are to examine larger institutions continuously. The Board of Governors of the Fed coordinates the examination and compliance activities of the 12 regional banks.
- **The Federal Deposit Insurance Corporation (FDIC).** The FDIC regulates about 4,800 state-chartered commercial banks and 500 state-chartered savings associations that are not members of the Fed. They also insure deposits of the remaining 4,000 depository institutions without regulating them. The FDIC examines its supervised institutions about once every 18 months.
- **The Office of Thrift Supervision (OTS).** The OTS supervises about 950 federally chartered savings associations, savings banks, and their holding companies. Like the OCC, the OTS is located within, but is independent of, the Treasury. The OTS is to conduct on-site examinations of each institution at least three times every two years.
- **The National Credit Union Administration (NCUA).** The NCUA currently regulates 9,369 federally chartered credit unions and another 3,593 federally insured, state-chartered credit unions. Most credit unions are small and considered to have limited risk exposure. Consequently, credit unions and NCUA are not covered further in this report.
- **The Securities and Exchange Commission (SEC).** The SEC regulates to protect investors against fraud and deceptive practices in securities markets. It also has authority to examine institutions it supervises for regulatory compliance. This covers securities markets and exchanges, securities issuers, investment advisers, investment companies, and industry professionals such as

broker-dealers. The SEC supervises more than 8,000 registered broker-dealers with approximately 92,000 branch offices and 67,500 registered representatives.

- The Commodity Futures Trading Commission (CFTC).**  
 The CFTC protects market users and the public from fraud and abusive practices in markets for commodity and financial futures and options. The CFTC delegates regulatory examinations to its designated self-regulatory organizations (DSROs), of which the most prominent are the National Futures Association (NFA), the Chicago Board of Trade, and the New York Mercantile Exchange. NFA membership covers more than 4,000 firms and 50,000 individuals. The regulatory process generally starts at registration, when the DSRO screens firms and individuals seeking to conduct futures business. The DSROs monitor business practices and, when appropriate, take formal disciplinary actions that could prohibit firms from conducting any further business.

## Safety and Soundness Regulations

Safety and soundness regulations for banks consist of basically five components: **federal deposit insurance** to reduce the likelihood of bank runs and panics; **deposit interest ceilings** to reduce the costs of bank deposits and weaken banks' incentives to invest in risky assets; **regulatory monitoring** to ensure that banks do not invest in excessively risky assets, have sufficient capital given their risk, have no fraudulent activities, and have competent management; **capital requirements** to provide incentives for banks not to take excessive risk; and **portfolio restrictions** to prohibit investment in risky assets.

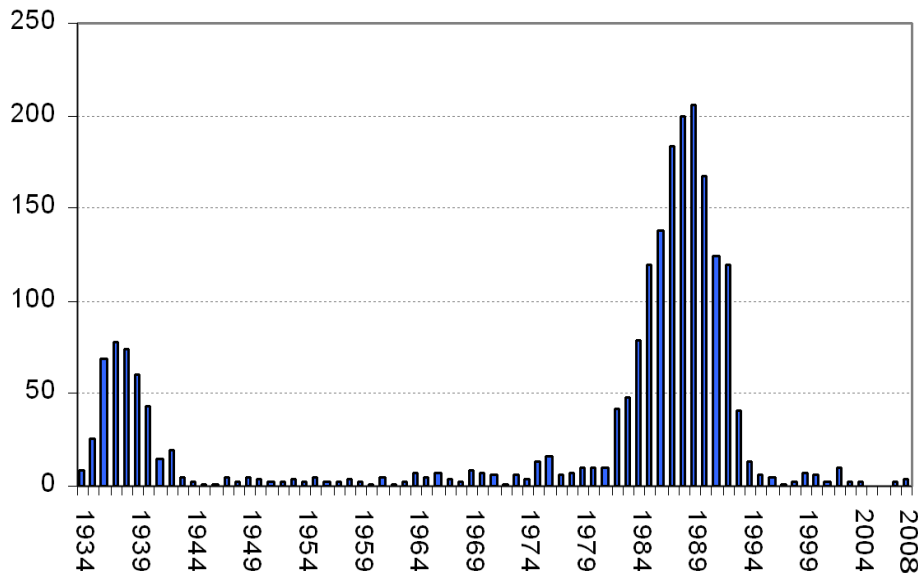
Under regulatory monitoring, U.S. banking regulators adopted a uniform rating system known as CAMEL to monitor banks' safety and soundness. "C" stands for capital adequacy; "A" stands for asset quality; "M" stands for management ability, "E" stands for earnings, and "L" stands for liquidity. The bank's capital is evaluated on the basis of the bank's size as well as the composition of its assets and liabilities, on and off the balance sheet. The quality of the bank's assets is determined by assessing the bank's credit risk of loans in its portfolio, which are classified as good, substandard, doubtful, or loss. Management ability is determined by evaluating the bank's management as well as its board of directors. The examiners assess competence, management acumen, integrity, and willingness to comply with banking regulations. Earnings are evaluated in terms of trends relative to the bank's peers. In determining the bank's liquidity, the examiners assess credit conditions, deposit volatility, loan commitments, and other contingent claims against the bank's capital, current stock of liquid assets, and the bank's perceived ability to raise funds on short notice. From the list of regulators above, one can see that bank examiners have overlapping jurisdictions. For example, national banks are also FDIC-Insured. Often federal and state examiners accept each others' examinations, and sometimes they

examine jointly. It is important to note that it is illegal to disclose a bank examination (for example, CAMEL ratings) outside the bank.<sup>1</sup>

## Background

A number of proposals to consolidate the federal regulatory structure of the financial services industry have been put forth. The United States, however, has yet to make any significant move in this direction. One reason is that most policymakers and knowledgeable observers believe that the functional, competitive regulatory structure of the United States has proven sound over time.<sup>2</sup> For example, the number of bank (a key financial services provider) failures would be among the indicators of the health of a financial services structure. **Figure 1** indicates that the number of bank failures have declined, since it peaked during the S&L crisis in 1989 when 206 depository institutions failed.

**Figure 1. The Number of FDIC-Insured Bank Failures, 1934-2008**



**Source:** FDIC 2007 Annual Report, Appendix A, p.107, and FDIC 2008 Failed Bank List, [http://www.fdic.gov/about/strategic/report/2004highlight/arhighlight.pdf], and [http://www.fdic.gov/bank/individual/failed/banklist.html].

**Figure 2** shows the ratio of the deposits of the failed institutions to the total deposits of FDIC-insured depository institutions ( failed institutions' deposits divided by total

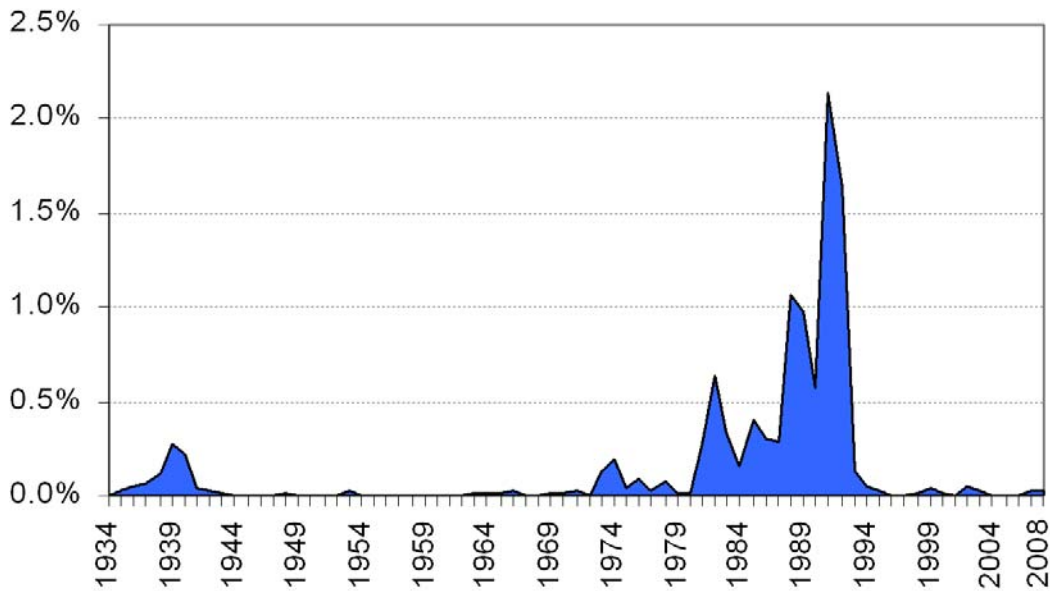
<sup>1</sup> See Stuart I. Greenbaum and Anjan V. Thakor, *Contemporary Financial Intermediation* (Orlando, FL: Dryden Press, 1995), pp. 514-521, or most finance textbooks.

<sup>2</sup> Melanie L. Fein, "Functional Regulation: A Concept for Glass-Steagall Reform," *Stanford Journal of Law, Business & Finance*, Spring 1995, pp. 89-90, and Jerry W. Markham, *Banking Regulation: Its History and Future* (Chapel Hill, NC: North Carolina Banking Institute, 2000), pp. 277, 285.



deposits). At its peak in 1991, 124 institutions failed but only a little more than 2% of the total banking deposits were held by these failed institutions. In contrast, at the end of 2006 no depository institution failed for the first time two in consecutive years since 1934. But the subprime turmoil that started in August of 2007 and the credit crunch that followed contributed to the failure of three small banks in 2007 and four in the first quarter of 2008.

**Figure 2. FDIC-Insured Bank Deposits: Ratio of Failed Bank Deposit to Total Bank Deposits, 1934-2008**



**Source:** FDIC 2007 Annual Report, Appendix A, p.107, and FDIC 2008 Failed Bank List, [<http://www.fdic.gov/about/strategic/report/2007highlight/arhighlight.pdf>], and [<http://www.fdic.gov/bank/individual/failed/banklist.html>].

The regulatory structure of the United States is said to be functional because regulators supervise by line of business such as banking, insurance, or securities trading. The structure is said to be competitive because there are usually multiple regulators responsible for a single function, for example, banking services.<sup>3</sup> Regulatory responsibilities are widely dispersed among several regulators on the federal as well as the state level of government.

The U.S. regulatory structure reflects historical evolution rather than deliberate design. The structure has evolved by addressing regulatory deficiencies on whatever level they are found. For example, federal regulation of banks occurred for the first time after the Civil War when states' management of their currencies failed dramatically. For the first time in the 1980s, the financial regulators addressed the savings and loan associations' (S&Ls) failures by abolishing the Federal Saving and Loan Insurance Corporation (FSLIC), creating the OTS as the S&Ls' new regulator

<sup>3</sup> Bert Ely, "Functional Regulation Flunks: It Disregards Category Blurring," *American Banker*, February 27, 1997, p. 4.

and requiring all insured-depository institutions to increase their capital by calculating their regulatory capital based on the riskiness of their assets. The purpose was to increase the protection of taxpayers from future bailouts of these institutions. More recently, the Sarbanes-Oxley Act created a new independent body, the Public Company Accounting Oversight Board to oversee auditors and established accounting standards for publicly traded companies in response to accounting fraud leading to the bankruptcy of several large publicly traded firms. In most cases, the U.S. regulatory structure has been able to handle most financial crises successfully before they significantly disrupt economy activity. The issue is the regulatory structure's capacity to continue to handle most financial crises given the increased interrelationships and functional commingling within the financial services industry.

The United Kingdom, Japan, and Germany recently consolidated and redesigned their financial services regulatory agencies to meet recent developments in the financial services markets. These recent developments included the blurring of boundaries among functions, need for a comprehensive approach to risk management, better allocation of regulatory resources, and the need to accommodate international regulatory negotiations on trade in financial services.

The Financial Services Authority in the United Kingdom (FSA-UK), the Financial Service Agency in Japan (FSA-Japan), and the Federal Financial Supervisory Authority (BaFin) in Germany provide a point of comparison for the U.S. structure. These foreign regulatory structures are said to offer more effective methods of regulating modern financial services firms.

## **U.S. Functional and Competitive Regulatory Structure**

U.S. regulation of financial services is dispersed among a number of regulators. For example, the FDIC and the OCC have regulatory responsibilities for national banks that are FDIC-insured. The OCC holds these banks' charters, and therefore determines the activities in which they may engage. The FDIC insures each of the institutions' deposit accounts for up to \$100,000 on which it must make good if the institutions fail. Proponents of the framework contend that competing regulatory bodies regulate less but do it more efficiently. The redundancy of regulators is more likely to detect and correct risky market behaviors before they develop into financial crises.<sup>4</sup>

The structure allows regulations to be tailored to the specific deficiencies at the appropriate level of the abusing firm(s). Also, the structure promotes innovations and competition among financial services providers. Opponents argue that the overlapping regulations are costly and allow astute financial services firms to exploit weaknesses along the regulatory seams. The structure also allows financial services

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<sup>4</sup> See the Board of Governors of the Federal Reserve System comments on the Government Accountability Report in U.S. Government Accountability Office, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO Report GAO-05-61, October 2004, p. 137, also see U.S. Task Group on Regulation of Financial Services, *Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services* (Washington: GPO, 1984), pp. 29-33.

providers to shop for the regulator that best suits their business plan. This was confirmed in a recent FDIC survey that shows that the top reasons given by the 34 banks that changed their charter to the FDIC were that “the FDIC was less expensive and more banker friendly, and that other regulators were stricter, and that institutions could more readily pursue market share increases.”<sup>5</sup> On the other hand, the ability to shop for regulators could lead to more institutions being regulated by the weakest regulators, which would increase systemic risk.

**Regulatory Competition in Banking.** In the beginning of the nation, the federal government exercised an indirect role in the regulation of banking through the First and Second Banks of the United States. When President Andrew Jackson refused to renew the Second Bank’s charter, states’ regulatory banking commissions filled the regulatory vacuum that was created.<sup>6</sup> The Civil War and the disarray of the national currencies led to the reintroduction of the federal government into regulating banks by establishing the national bank charter system, which was governed by the Comptroller of the Currency (OCC) established in 1863.<sup>7</sup> Its creation immediately began the dual banking system which exists today and placed the federal government in competition with states for the number and size of banks under their respective jurisdictions. Until recently, most bankers preferred state charters because states’ regulations were considered less burdensome.

More layers to the regulatory structure, and therefore competition between regulators, were added with the creation of the Federal Reserve Board after the Panic of 1907 and the creation of the Federal Deposit Insurance Corporation (FDIC) after the banking failures of the Great Depression in the 1930s. Further layers of regulatory competition were added when saving banks and credit unions were provided with separate federal regulators which evolved into the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA).<sup>8</sup> The Great Depression also led Congress to pass the Glass-Steagall Act of 1933 (Ch.89, 48 Stat.162) to further seal off banking from other financial services enterprises by prohibiting banks from engaging in investment banking activities until it was repealed by the Gramm-Leach-Bliley Act of 1999 (GLBA) (P.L. 106-102). It repealed the Glass-Steagall Act and allows financial companies owning or operating institutions to commingle financial services.

**Regulatory Competition in Insurance.** Like banking, the insurance industry owes its competitive regulatory structure to correcting deficiencies. States began regulating insurance in 1837, starting with Massachusetts and New York, to

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<sup>5</sup> BNA Banking Report, “Bank Supervision ‘Burdensome’ Regulations Complaint In FDIC Ombudsman Surveys, Agency Says,” *BNA’s Banking Report*, March 28, 2005, p. 1. See the original report at [<http://www.fdic.gov/regulations/resources/ombudsman.html>].

<sup>6</sup> Jerry W. Markham, *Banking Regulation: Its History and Future* (Chapel Hill, NC: North Carolina Banking Institute, 2000), pp. 226-227.

<sup>7</sup> National Bank Act of 1863, ch. 106, 13 stat. 99.

<sup>8</sup> Broome and Markham, *Regulation of Bank Financial Service Activities* (New York: West Publishing, 2001), pp. 78-81, 87.

ensure that insurance companies maintained adequate reserves to meet claims.<sup>9</sup> In the early 1920s, states significantly increased legislative restrictions on insurance companies, starting in New York and copied by other states. A New York legislature's investigation uncovered massive insurance companies' abuses that left them without adequate reserves to pay claims. That led to the New York state's legislature passing laws barring companies from underwriting insurance while underwriting other securities.

Copying New York state's regulations, states separated insurance companies from the banking industry.<sup>10</sup> These regulatory provisions also protected the insurance industry from the excesses of the securities industry in the late 1920s that led to the stock market crash. Consequently, when the stock market crashed in 1929, the insurance companies were in relative good shape.<sup>11</sup> Having escaped the massive failures of the other parts of the financial services sector, the insurance companies were not included in New Deal regulatory legislation, even though in 1934 the Securities and Exchange Commission (SEC) proposed a federal agency to regulate insurance companies. The proposal was soundly rejected upon objections from the industry and state regulators.<sup>12</sup>

Another possible expansion of federal regulation of insurance came in 1944 out of a Supreme Court ruling which held that the insurance industry was subject to the federal antitrust laws.<sup>13</sup> The insurance industry feared that this ruling would preempt their state regulation. As a result, the industry lobbied Congress heavily to pass the McCarran-Ferguson Act, which granted insurance companies immunity from the antitrust laws to the extent that they were regulated by state insurance laws.<sup>14</sup> The McCarran-Ferguson Act protected the insurance industry until the early 1950s when insurance companies began selling variable annuities, which the SEC challenged. The SEC argued that variable annuities were securities subject to its regulation because the returns on these investments were based on investment of the annuitants' premium payments in securities. The Supreme Court found for the SEC. Insurance

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<sup>9</sup> Broome and Markham, "Banking and Insurance: Before and After the Gramm-Leach-Bliley Act," *Journal of Corporation Law*, summer 2000, p. 727.

<sup>10</sup> *Ibid.*, p. 731.

<sup>11</sup> Temporary National Economic Committee (TNEC), *Investigation of the Concentration of Economic Power*, Monograph No. 28A: Statement on Life Insurance, 76<sup>th</sup> Congress, 2<sup>nd</sup> sess., 1941, pp. 2, 107.

<sup>12</sup> Broome and Markham, "Banking and Insurance: Before and After the Gramm-Leach-Bliley Act," p. 732.

<sup>13</sup> *United States v. South-Eastern Underwriters Association*, 322 U.S. 533 (1944).

<sup>14</sup> Jerry W. Markham, "A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan," *Brooklyn Journal of International Law*, 2003, p. 4.

companies selling variable annuity contracts are now regulated by states and the SEC.<sup>15</sup>

The insurance industry was able to stave off other federal intrusions, despite suffering significant losses from contracts sold in the 1980s.<sup>16</sup> The industry, however, could not avoid competition from the banking and securities industries.<sup>17</sup> One reason was that variable annuities became a growing line of financial services products sold by stockbrokers. In addition, federal bank regulators began allowing banks to sell insurance products in the 1990s.<sup>18</sup> This competition resulted in many insurance companies demutualizing<sup>19</sup> and expanding their own financial service offerings, such as more securities-like products with banking services options.<sup>20</sup> In sum, even though regulatory competition was maintained with the states, state insurance regulators could not protect insurance companies from competition from other financial services providers. There have been several legislative proposals in recent years to impose federal regulation on some companies who offer securities-like products with banking services options.<sup>21</sup>

**Regulatory Competition in Securities.** When the Securities and Exchange Commission was created by Congress in 1934 — in the wake of the stock market crash of 1929 — it was to establish a strong federal regulatory presence in the market for corporate securities.<sup>22</sup> The SEC’s main focus was full disclosure in the securities markets. The Securities and Exchange Act of 1934 did not preempt state securities regulations. Consequently, the SEC has competed with state securities regulators for

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<sup>15</sup> Broome & Markham, “Banking and Insurance: Before and After the Gramm-Leach-Bliley Act,” p. 737.

<sup>16</sup> *Ibid.*, p. 739.

<sup>17</sup> Cedric V. Fricke, *The Variable Annuity: Its Impact on the Savings-Investment Market*, Bureau of Business Research, School of Business Administration, University of Michigan, 1959, 90 p.

<sup>18</sup> For example, states were unable to restrict banks from selling insurance following banks’ victories in the courts. See *U.S. National Bank of Oregon v. Independent Agents of Agents of America*, 508 U.S. 439 (1993), and *Barnett Bank of Marion County N.A.B. Nelson*, 517 U.S. 25 (1996).

<sup>19</sup> Many insurance companies changed from being owned by their customers to publicly owned companies. See Broome & Markham, *Banking and Insurance: Before and After the Gramm-Leach-Bliley Act*, pp. 19, 745-746.

<sup>20</sup> See CRS Report RL32138, *Revising Insurance Regulation: Policy Considerations*, by Baird Webel and Carolyn Cobb.

<sup>21</sup> See U.S. Congress, Senate Committee on Commerce, Science, and Transportation, *Federal Involvement in the Regulation of the Insurance Industry*, hearing, 108<sup>th</sup> Cong., 1<sup>st</sup> sess., October 22, 2003, available at [<http://www.commerce.senate.gov>].

<sup>22</sup> Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (New York: Aspen Publishing, 1995), p. 45.

most of its existence.<sup>23</sup> With the exception of mortgage-backed securities in 1984, it was not until the National Securities Markets Improvement Act of 1996 that some of the states' securities regulations were preempted or states were required to conform their standards to those of the SEC.<sup>24</sup> Federal securities law and SEC regulations apply to the markets where securities are traded and to all businesses that sell stocks or bonds to public investors. Other regulated entities include mutual funds, bidders in corporate mergers and acquisitions, certain investment advisers, public accountants, and power utilities (the SEC has some control over the market structure under the Public Utility Holding Company Act of 1935).<sup>25</sup>

In this securities regulatory structure, regulatory competition remains in the form of self-regulatory organizations (SROs). These are non-governmental organizations that were given regulatory authority and shelter from the antitrust laws by the Securities and Exchange Act of 1934.<sup>26</sup> SROs like the securities exchanges and the National Association of Securities Dealers, Inc. (NASD) are required to regulate the conduct of their members. The SEC's role is to oversee the exchanges, as well as act directly when the SROs' oversight fails.<sup>27</sup>

In addition to the SROs, the structure of securities regulation also includes accountants that certify the financial statements of public companies and broker-dealers as well as the Nationally Recognized Statistical Ratings Organizations (NRSROs). The NRSROs include rating agencies such as Moody and Standard & Poor's. The SEC's ability to enforce its rules over accountants and broker-dealers has been strengthened by the Sarbanes-Oxley Act of 2002, which created a Public Company Accounting Oversight Board to oversee the auditing principles of auditors. Sarbanes-Oxley also requires the SEC to conduct a study of NRSROs and to report to Congress on any deficiencies. Concerns about conflict of interest and certification have resulted in the Senate Committee on Banking, Housing, and Urban Affairs holding hearings on the regulation of NRSROs.<sup>28</sup>

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<sup>23</sup> Jerry W. Markham, "A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan," p. 4.

<sup>24</sup> *Ibid.*, p. 34.

<sup>25</sup> See the Securities and Exchange Commission section by Mark Jickling in CRS Report RL32309, *Appropriations for FY2005: Commerce, Justice, State, the Judiciary, and Related Agencies*, coordinated by Ian F. Fergusson and Susan B. Epstein.

<sup>26</sup> Self-regulation by the National Association of Securities Dealers was added in 1938 by the Maloney Act, 52 Stat. 1070 (Codified as amended at 15 U.S.C. § 780-3 (2000)).

<sup>27</sup> Jerry W. Markham, "A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan," p. 5.

<sup>28</sup> Alec Klein, "Debt-Rating Firms Resist Prospect of More Supervision" *The Washington Post*, February 9, 2005, p. E-2. For testimonies presented at the Senate hearing, see [<http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=136>].

**Regulatory Competition in Commodity Futures and Options.** Like the other financial services, commodities futures were separated from the rest of the industry as part of historical regulatory development in the United States. The agricultural recession of 1921 following World War I, and speculative manipulation of commodity prices prompted Congress to pass the Grain Futures Act of 1922 under its commerce powers.<sup>29</sup> The Grain Futures Act required commodity futures trading to be conducted on organized exchanges, such as the Chicago Board of Trade, which would register with the government as contract markets. With commodity speculation and market manipulation unchecked in the Great Depression, President Roosevelt added regulation of the commodity markets to his request for regulation of the securities market. Congress responded with the Commodity Exchange Act of 1936 (CEA), which continued many of the requirements of the Grain Futures Act, but required futures commission merchants (the equivalent to broker-dealers in the securities business) to register with the government.<sup>30</sup>

For decades, even though options trading of regulated commodities, and manipulation of commodity prices, were prohibited, the government was unable to stop speculation and manipulation in commodity prices, particularly in options on unregulated commodities which added to the rapid rise in commodity prices in the early 1970s. The Commodity Futures Trading Commission Act of 1974 was enacted in response to developments in the commodities markets which carried forward the Commodity Exchange Act and created the CFTC.<sup>31</sup>

The CFTC was given exclusive jurisdiction over the trading of commodity futures and commodity options on all commodities and it was given more enforcement powers than its predecessor. Its regulatory reach included commodity trading advisors, commodity pool operators, and associated persons of futures commission merchants.<sup>32</sup> Despite the increased federal regulation of the commodity trade, the regulatory control of commodity trade remained less stringent than SEC's control of trade in securities. Competition between the SEC and the CFTC developed when the financial services industry began developing new financial instruments and trading strategies that converged on products regulated by both regulators — stock index futures, and other equity-based derivatives. The difference in the level of regulation in the securities and the commodity futures and options markets became important to investors. Over-the-counter (OTC) instruments such as swaps, caps, collars, and floors were increasingly popular alternatives to exchange-traded commodity futures and options. Some of these instruments were abused by

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<sup>29</sup> The Futures Trading Act of 1921, Ch.86, 42 Stat. 187 (1921) was found unconstitutional by the Supreme Court as an impermissible use of the congressional taxing powers. See Jerry W. Markham, "A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan," p. 7.

<sup>30</sup> *Ibid.*, pp.7-8.

<sup>31</sup> Jerry W. Markham, "Manipulation of Commodity Futures Prices — The Unprosecutable Crime," *Yale Journal on Regulation*, vol. 8, 1991, p. 281.

<sup>32</sup> Jerry W. Markham, *History of Commodity Futures Trading and Its Regulation* (New York: Praeger, 1987), pp. 66-72.

both SEC- and CFTC-regulated firms and traders. In 1978, Congress mandated that the two agencies consult with each other and with banking regulators in curtailing these abuses.<sup>33</sup>

The over-the-counter market for derivatives was the source of regulatory competition between the CFTC and the banking regulators — the Fed and the OCC. The banking regulators argued for no regulation of OTC financial derivatives, even though Congress had given the CFTC exclusive jurisdiction over all contracts and mandated that all such contracts be traded on CFTC-regulated exchanges. However, the CFTC did not move to assert its regulatory jurisdiction over these derivative contracts. The lack of regulation provided a legal risk to swaps contracts. That is, if a court had ruled that swaps were illegal, trillions of dollars in OTC derivative contracts might have been rendered void and unenforceable.<sup>34</sup>

The Commodity Futures Modernization Act of 2000 (CFMA; P.L. 106-554) was enacted to clarify the situation. It specifies that the CEA does not apply to contracts between “eligible contract participants” (which include financial institutions, regulated financial professionals, units of government, nonfinancial businesses or individual persons with assets more than \$10 million, and others whom the CFTC may approve) based on “excluded commodities.” Excluded commodities are defined as financial products and indicators, and are thought to be less susceptible to manipulation than physical commodities with finite supplies. Derivatives based on agricultural commodities, however, may be traded only on CFTC-regulated exchanges, because of concerns about price manipulation — “corners” and “squeezes” — in those markets.<sup>35</sup>

## The Problem of Regulating in the Current Environment

Today, financial services, such as banking, insurance and securities trading are no longer specific to an institution. Insurance, for instance, does not have to be bought from an insurance company; instead it can be purchased from a bank with little or no differentiation in the policy being delivered to the customer. Since the 1980s, financial services companies increasingly commingle financial services. The passage of P.L. 106-102, the Gramm-Leach-Bliley Act of 1999, incorporated the commingling of financial services within institutions into U.S. financial services law.

In this new GLBA framework, the responsibilities of regulating financial institutions are more difficult to achieve because the regulators no longer have the separation of the lines of businesses that they had in the past. Technological advances have helped to erase the traditional lines of demarcation in financial services products upon which the regulatory structure was built. Bank regulators, for example, continue to lower barriers to bank entry into commodity futures and options businesses, and insurance has become a popular bank product. As bankers get more

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<sup>33</sup> Ibid., pp. 99-100.

<sup>34</sup> CRS Report RS20560, *The Commodity Futures Modernization Act (P.L. 106-554)*, by Mark Jickling.

<sup>35</sup> Ibid., p. 3.



involved in the securities business, the business has been changing rapidly. Maintaining a regulatory structure and control based on past established market behavior that is now slowly disappearing raises questions about the effectiveness of the structure to manage the changing risks. Most regulatory changes have occurred after the risks have risen sufficiently to show the deficiencies.

## Proposed Consolidation Solutions

The most recent proposal to consolidate the federal regulatory structure of financial services industry is the *Department of the Treasury Blueprint for a Modernized Regulatory Structure* (the Blueprint). It was motivated by the Bush Administration's recognition that the existing functional regulatory framework no longer provides efficient and effective safeguards against poor prudential behavior of financial services firms.<sup>36</sup> The Administration believed that the existing framework is based on a structure that has been largely knitted together more than 75 years to address specific economic disruptions and is not optimal because financial institutions have become more opaque and more difficult to understand as the institutions develop new products and complex risk-hedging strategies that are difficult to evaluate.

For these reasons, on March 31, 2008, Treasury Secretary Henry Paulson offered the Blueprint as a more optimal federal financial regulatory structure. This proposed framework would consolidate similar functions more than it would consolidate agencies by renaming existing regulatory agencies and make significant changes in their responsibilities, and functions. There will be five major regulatory agencies which is the same number as there are federal banking regulators: a market stability regulator, which is essential the monetary and lender of last resort functions of the Federal Reserve; a prudential regulator, which would enforce the safety and soundness prudential regulations that are shared by all existing regulators; a business conduct regulator, which is a consumer and business protection regulator whose functions are now shared by all regulators and particularly the SEC/CFTC; a federal insurance regulator, which is essentially the Federal Deposit Insurance Corporation with additional insurance responsibilities preempted from states, and a corporate financial regulator, which is essentially the SEC/CFTC and related self regulated organizations, such as the securities exchanges.

The financial services industry's reaction to the Blueprint has been mixed with the criticisms outweighing the support of the proposal. Banking groups supported the prospects of regulatory modernization, but were critical of the Blueprint's plan to eliminate the thrift and credit union charters along with their supervisory agencies — the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA). On the other hand, the mortgage bankers supported the Blueprint arguing that it would lead to resolving regulatory inconsistencies in mortgage lending supervision at the state level. For insurance, most smaller insurance companies opposed the Blueprint's optional federal charter, which would give insurance companies the option of federal regulation rather than the existing

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<sup>36</sup> The Department of the Treasury, *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure*, March, 2008. 218pp.

state regulation of insurance companies. By contrast, large insurance companies operating in several states supported the optional federal charter proposal, while state insurance commissions were quick to oppose the Blueprint's insurance proposal. The commissioners argue that they support needed modernization but that does not mean federalization. On the securities and futures markets, the Blueprint proposes to merge the SEC with the CFTC, which has been proposed before as shown below, but has not happened.

Congress and regulators in the first term of the George W. Bush Administration raised the long-standing issue of consolidating federal financial services regulators.<sup>37</sup> The former U.S. Treasury Undersecretary for Domestic Finance, Peter R. Fisher, made an argument that the supervisory process of the financial services industry should remain diverse, and aimed at the risk-bearing parts of financial firms. However, he strongly advocated creating one regulator to write rules and regulations. This single regulatory agency — a super-regulator — should be responsible for only this activity.<sup>38</sup> Such an agency would absorb the regulation-making functions of all the major federal financial regulators. The George W. Bush Administration's restructuring efforts for financial services regulators was later shifted to oversight of particular institutions such as the government-sponsored housing enterprises Fannie Mae and Freddie Mac.

An even earlier suggested reform of the federal financial regulatory agencies was put forth in 2002 by Donald E. Powell, Chairman of the Federal Deposit Insurance Corporation. Chairman Powell proposed to design a new regulatory system that would reflect the modern financial services marketplace. Three federal financial services regulators would carry out federal supervision. One would be responsible for regulating the banking industry, another for the securities industry, and a third for insurance companies that choose a federal charter.<sup>39</sup> Under this proposal, regulators like the OCC would be restructured out of existence.

Along this line of thinking there have been other regulatory restructuring plans for the financial services industry by sectors:

**Banking.** During the Clinton Administration, Secretary of the Treasury Lloyd Bentsen proposed that certain functions of the Federal Reserve, the FDIC, the OCC, and the OTS be combined into an independent agency called the Federal Banking Commission. This commission would have been responsible for bank regulation and

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<sup>37</sup> See Donald E. Powell, Federal Deposit Insurance Corporation Chairman, *Why Regulatory Restructuring? Why Now?*, Delivered at the Exchequer Club, Washington DC, November 16, 2002. The FDIC also sponsored a symposium entitled, "The Future of Financial Regulation: Structural Reform or the Status Quo?," March 13, 2003. The American Enterprise Institute conducted a similar conference on February 21, 2003 entitled, *Is Consolidated Financial Regulation Appropriate for the United States?* [<http://www.aei.org>].

<sup>38</sup> Kim Betz, "Super Regulator Could Aid Consistency in Financial Services Rule Writing Process," *BNA Banking Report*, September 23, 2002, p. 1.

<sup>39</sup> Don Powell, Remarks before the Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, Chicago, IL, May 2002, p. 2, [<http://www.fdic.gov/news/news/speeches/archives/w00w/sp1may02.html>].

supervision. The FDIC would have remained responsible for administering federal deposit insurance, and the Federal Reserve would have retained its central banking responsibilities for monetary policy, liquidity lending, and the payments system. However, both the FDIC and the Fed would lose most of their bank supervisory rule-making authority to the Banking Commission.<sup>40</sup>

In 1994, former Federal Reserve Governor, John P. LaWare recommended combining the OCC with the OTS. The combined agencies would form an independent Federal Banking Commission. The Federal Reserve would supervise all independent state banks and all depository institutions in any holding company whose lead institution was state chartered. The commission would have supervised all independent national banks and thrifts. The FDIC would not have independent examination powers but would be authorized to join in the examination of problem banking institutions. In 1996, the GAO recommended that primary supervisory responsibilities of the OTS, OCC, and the FDIC be consolidated into a new, independent Federal Banking Commission. The Commission and the Federal Reserve would be responsible for supervision of banking organizations.<sup>41</sup>

**Insurance.** Since there is no federal insurance regulatory agency, the issue becomes, should one be created. Bills have been introduced in Congress to create some federal regulation of the insurance industry. These bills have been supported by several insurance trade associations. In the 107<sup>th</sup> Congress, the Insurance Industry Modernization and Consumer Protection Act (H.R. 3766)<sup>42</sup> proposed optional federal charters for insurance companies that would have created a dual system, on the federal and state levels of government. H.R. 3766 would have required the creation of a federal regulatory agency for insurance. In the 108<sup>th</sup> Congress, the Insurance Consumer Protection Act (S. 1373) would have created a federal commission within the Department of Commerce to regulate the interstate business of property-casualty and life insurance and require federal regulation of all interstate insurers. Unlike the bills in the 107<sup>th</sup> Congress which made federal regulation optional for insurance companies, the bill in the 108<sup>th</sup> Congress would have pre-empted most current state regulation of insurance.<sup>43</sup>

A draft bill which began circulating in August 2004 entitled the State Modernization and Regulatory Transparency Act, is quite different from previous proposals. It would establish uniform standards for almost every area of the insurance business including market conduct, product and producer licensing, life

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<sup>40</sup> U.S. Senate Committee on Banking, Housing, and Urban Affairs, *Banking Industry Regulatory Consolidation*, hearings, 103<sup>th</sup> Congress, 2<sup>nd</sup> sess., March 1, 1994, pp. 44-66.

<sup>41</sup> U.S. Government Accountability Office, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO Report GAO-05-61, October 2004, p. 77.

<sup>42</sup> See CRS Report RS21153, *Optimal Federal Chartering for Insurers: Legislation and Viewpoints*, by S. Roy Woodall Jr.

<sup>43</sup> U.S. Government Accountability Office, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO Report GAO-05-61, October 2004, p. 81.

insurance, property and casualty insurance, and reinsurance. It would preempt state laws if these laws were not made to conform to its uniform standards<sup>44</sup>

**Securities.** The regulatory competition between the SEC and the CFTC has brought about several proposals to combine the two agencies. As mentioned previously, the changes in the financial services industry have led to the development of financial instruments that appear to fall into the jurisdiction of both the SEC and the CFTC.<sup>45</sup> To solve the problem, in the 1990s, the Treasury proposed three alternative solutions: combining the SEC and the CFTC, giving the SEC regulatory authority over all financial futures, or transferring regulation of stock index futures from the CFTC to the SEC. In a hearing concerning the Markets and Trading Reorganization and Reform Act of 1995, (H.R. 718) that would have merged the CFTC and the SEC, the GAO pointed out to those considering the merger the difficulty of quantifying both the potential benefits and risks. The GAO also noted that a merger might yield only small budgetary cost savings.<sup>46</sup> As an alternative to consolidation, the Commodity Futures Modernization Act of 2000 specified the respective jurisdictions of the two agencies and mandate that the two agencies negotiate their jurisdictional disputes as they may occur in the future. The Blueprint also proposed combining the SEC and the CFTC.

## Consolidation in Other Countries

Most of the arguments used in other countries to justify a consolidation of financial services regulatory structure are applicable to the United States. These arguments were successful in convincing several of the United States' major trading partners to consolidate their financial services regulators into a single regulatory agency or authority. The key arguments were:<sup>47</sup>

- The financial services industry has changed in ways that blur the clear-cut boundaries between the functional areas of banking, insurance, securities, and commodities markets.
- While the financial services firms are primarily responsible for effectively managing their risks, the nature of the risks has created a need for the government to take a more comprehensive approach to regulating those firms' risk management procedures.

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<sup>44</sup> CRS Report RL32789, *Insurance Regulation: Issues, Background, and Current Legislation*, by Baird Webel.

<sup>45</sup> Jerry W. Markham, "A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan," *Brooklyn Journal of International Law*, 2003, p. 17.

<sup>46</sup> U.S. Government Accountability Office, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO Report GAO-05-61, October 2004, p. 78.

<sup>47</sup> *Ibid.*, p. 68; and see the Bafin's 2002 Annual Report, p. 9, at [[http://www.bafin.de/jahresbericht/jb02\\_e\\_TeilA.pdf](http://www.bafin.de/jahresbericht/jb02_e_TeilA.pdf)].

- The functional regulatory structure is not conducive to comprehensively understanding the appropriate risk-taking activities of large, complex, international firms. Furthermore, the functional regulatory structure does not have the ability to allocate resources across agencies to carry out strategically focused priorities.
- A consolidated financial services regulator at the national level is more suited to accommodate international regulatory negotiations on financial services regulations and supervision, such as capital, accounting, and privacy standards.

Among the countries that have adopted a single national regulator are the United Kingdom, Japan, and Germany. In all three countries, the new agencies are generally recognized as the sole financial services supervisors. However, to a varying extent, the traditionally dominant regulators such as the central bank, and/ or the ministry of finance still have important roles to play in the new consolidated framework. In addition, in contrast to the American competitive regulatory model, these countries' financial services sectors have been closer to a monolithic regulatory structure than the United States. In Europe, for example, through universal banking, banks have a long tradition of providing banking services as well as trade in securities and insurance, and the central banks and/or ministry of finance were the dominant regulators.<sup>48</sup>

**Financial Services Authority of the United Kingdom.** In 1997, the Financial Services Authority of the United Kingdom (FSA-UK) consolidated financial services regulation in the UK by combining nine regulatory bodies. FSA-UK was given the responsibility to regulate virtually every aspect of financial services. To compare with the United States, FSA-UK has the roles played by the federal and state banking agencies, the SEC, the CFTC, insurance and securities commissions, as well as the SROs.<sup>49</sup> It was also given expanded independent enforcement powers enabling it to bring action against violators and impose sanctions. FSA-UK has a single ombudsman to handle complaints by consumers in all financial services. This is in contrast to the numerous hotlines to the various federal and state agencies in the United States. Another remarkable provision of the FSA-UK is that it assigns one office to develop policies on capital requirements for all financial sectors (similar to the Fisher proposal mentioned previously). By comparison, in the United States, the assessment of risks and capital requirements are developed separately for insurance, banks, broker-dealers, and futures commission merchants.

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<sup>48</sup> Anthony Saunders and Ingo Walter, *Universal Banking in the United States* (New York: Oxford University Press, 1994), p. 276.

<sup>49</sup> Jerry W. Markham, "A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States the United Kingdom, and Japan," *Brooklyn Journal of International Law*, 2003, p. 19.

The FSA-UK is organized as a private corporation with a chairman and a chief executive officer and 16-person board of directors. Eleven members of the board are independent. The FSA-UK is answerable to the Treasury and the British Parliament. A practitioner panel and a consumer panel oversee FSA-UK for their respective constituencies. There is also a requirement for consultation on rules and an appeals process for enforcement. FSA-UK organization strategy is to focus on the most damaging potential risks to the financial system. Consequently, it generally targets larger financial firms. It is required to furnish cost-benefit analyses for its proposals and report annually on its costs relative to the cost of regulations in other nations.<sup>50</sup>

Most financial firms under the FSA-UK and the International Monetary Fund (IMF) have reported that the FSA-UK has been successful in regulating the financial services industry in the United Kingdom.<sup>51</sup> However, a major financial crisis came to light in 2001 that caused FSA-UK to reexamine its regulatory activities in the insurance sector. Equitable Life is a mutual insurer that sold policies in the high interest environment of the 1980s without setting aside the necessary reserves for these policies. While Equitable Life assured pensioners that its assets would exceed its liabilities for years, in 2001 the stated value of its customers' policies was £4.4 billion more than Equitable's assets were worth. Consequently, the company slashed its pension holders' policy value by 16%.<sup>52</sup> A major study of the crisis blamed the "light touch, reactive regulatory environment" that preceded the FSA-UK. In response to the crisis, FSA-UK has become more aggressive in regulating the insurance sector, and has begun a program of enforcement actions, imposing fines and banning wrongdoers from the industry.<sup>53</sup> In the 2002 the International Monetary Fund found that "the insurance industry is under considerable stress, reflecting depressed investment returns, declining profitability in base life insurance products, and, more recently, increasing regulatory compliance cost as the FSA introduces more stringent prudential supervision."<sup>54</sup>

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<sup>50</sup> U.S. Government Accountability Office, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO Report GAO-05-61, October 6, 2004, p. 66.

<sup>51</sup> International Monetary Fund, *United Kingdom: 2002 Article IV Consultation — Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the United Kingdom*, Country Report no. 03/48, February 2003, pp. 31-32.

<sup>52</sup> Andrew Verity, "Where Equitable Life Went Wrong," *BBC News*, March 9, 2004, p. 1, [<http://news.bbc.co.uk/1/hi/business/3547441.stm>].

<sup>53</sup> U.S. Government Accountability Office, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO Report GAO-05-61, October 6, 2004, p. 66. Jerry W. Markham, "A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan," p. 20, and James Mackintosh, and James Archer, "Banned from City Trading for Shares Deception," *Financial Times*, July 28, 2001, p. 3.

<sup>54</sup> International Monetary Fund, *United Kingdom: 2002 Article IV Consultation — Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the United Kingdom*, Country Report no. 03/48, February 2003, p. 31.

**The Financial Services Agency of Japan.** In 2000, the Financial Services Agency (FSA-Japan) was established by renaming the Financial Supervisory Agency (created in 1998) and transferring the Securities Exchange Surveillance Commission (SESC) of the ministry of finance along with other functions and staff from the ministry of finance to FSA-Japan. The SESC was created in 1992 to police the securities markets. Besides SESC, there are three bureaus: the planning and coordination bureau, the inspection bureau, and the supervision bureau. The planning and coordination bureau is responsible for the administration of relevant laws including the deposit insurance law. The inspection bureau is responsible for examining and supervising the accounting profession and auditing standard for financial institutions as a whole. The supervision bureau is responsible for the supervision of insurance companies, securities firms, and all financial institutions under FSA's jurisdiction. FSA-Japan is responsible to the minister for financial services, a member of the Cabinet answerable to the Diet (Japan's legislature) for legislative matters. He has effective management control over FSA. All significant reports on individual institutions are referred to him. However, FSA's management is the responsibility of the Commissioner and his staff. There is no board of directors.<sup>55</sup>

The legislation creating FSA-Japan allowed the establishment of previously banned holding companies which increased the size and diversification of banks.<sup>56</sup> In addition, consumer protection was enhanced through the law concerning the sale of financial products. After World War II General Douglas MacArthur required Japan to adopt U.S. laws regulating finance, including securities, and the Glass-Steagall Act.<sup>57</sup> Although insurance is under FSA-Japan, the agency has not made a strong effort to bring about the promised reform of the insurance industry. It was not until several insurance companies failed that FSA-Japan increased regulatory control over the industry by requiring mark-to-market accounting and increased solvency margins.<sup>58</sup>

FSA-Japan's performance to date has been criticized heavily. The IMF raised questions about the independence and enforcement powers of the agency.<sup>59</sup> The ministry of finance, combined with the Bank of Japan, was essentially the monolithic financial services regulator. They were the managers of the economy, business

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<sup>55</sup> International Monetary Fund, *Japan: Financial System Stability Assessment and Supplementary Information*, Country Report no. 03/287, Washington, September 2003, p. 76.

<sup>56</sup> For more detailed FSA-Japan information see [<http://www.fsa.go.jp/en/about/about03.pdf>].

<sup>57</sup> Jerry W. Markham, "A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States the United Kingdom, and Japan," *Brooklyn Journal of International Law*, 28, 319, 2003, p. 20.

<sup>58</sup> *Ibid.*, p. 19.

<sup>59</sup> International Monetary Fund, *Japan: Financial System Stability Assessment and Supplementary Information*, Country Report no. 03/287, Washington, September 2003, pp. 47, 65, 77.

promoters, and it has been argued that they continue to exert significant influence over FSA-Japan limiting FSA-Japan's effectiveness. An example of this criticism is that SESC, a sub-agency of FSA-Japan, lacks a strong enforcement mechanism. It has only the power to investigate and not the authority to impose sanctions, but must refer matters of sanction to the commission.<sup>60</sup>

FSA-Japan's poor regulatory performance was reflected in bank regulation. It has shored up some troubled large banks while allowing them to keep their bad debt instead of urging them to write off these bad debts.<sup>61</sup> The government nationalized Credit Bank of Japan and Nippon Credit Bank after they could be no longer kept afloat and public funds were also injected into all but one major bank.<sup>62</sup> Most recently, FSA-Japan has pushed for market solutions and encouraged banks to merge, and offering endorsed government guarantees.<sup>63</sup>

On the positive side, the financial condition of the banking system continues to improve. The ratio of nonperforming loans to total assets has declined from 8% in 2001 to 3% in 2004. In the same time period, the capital adequacy ratio has risen from less than 8% to 11.6%. FSA-Japan has improved recognition and provisioning or bad loans.<sup>64</sup> FSA-Japan increased public disclosures of financially troubled financial services firms. It raised overall bank capital in Japan, even though some bank capital remains below the Basel minimum international standard. In addition, FSA-Japan allowed banks to sell life and other insurance. It also allows banks to affiliate with brokers. FSA-Japan has also lowered barriers to entry by foreign financial services firms.<sup>65</sup>

**The Federal Financial Supervisory Authority (BaFin).** In 2002, Germany consolidated its banking, securities, and insurance regulators into BaFin, which was the federal banking regulator. The new structure kept the old divisions

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<sup>60</sup> Jerry W. Markham, "A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States the United Kingdom, and Japan," p. 23, and International Monetary Fund, *Japan: Financial System Stability Assessment and Supplementary Information*, Country Report no. 03/287, Washington, September 2003, p. 44; David Pilling, "Regulator Drafts Plan for Japanese Bank Mergers," *Financial Times*, July 11, 2002, p. 10.

<sup>61</sup> International Monetary Fund, *Japan: Financial System Stability Assessment and Supplementary Information*, Country Report no. 03/287, Washington, September 2003, p. 13.

<sup>62</sup> Alexandra Nusbaum, "Investment Trust Hopes Lift Tokyo," *Financial Times*, January 29, 2000, p. 24.

<sup>63</sup> Phred Dvorak, "Japan's Central Bank Will Buy Stocks Held by Troubled Lenders," *Wall Street Journal*, September 19, 2002, p. A-1.

<sup>64</sup> International Monetary Fund, *Japan: 2005 Article IV Consultation — Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion*, IMF Country Report No. 05/273, August 2005, p. 9.

<sup>65</sup> Hakuo Yanagisawa, "Japan's Financial Sector Reform: Reform: Progress and Challenges," address to the Financial Services Authority, September 3, 2001, [<http://www.fsa.go.jp/gaiyou/gaiyoue/presen/p200010903.html>].



of financial services — banking, securities, and insurance. While the banking and insurance divisions are in Bonn, the securities division is in Frankfurt, home of Germany's stock market. As a federal agency, BaFin is under the oversight of the ministry of finance. It has a board of directors composed of the ministers of finance, economics, and justice, members of Parliament, officials of the Bundesbank, and representatives of the banking, insurance, and securities sectors. Like the other consolidated regulators, BaFin has an advisory council made up of industry, unions, and consumer representatives.<sup>66</sup>

A significant part of the impetus for creating BaFin was the European Union's Financial Services Action Plan for a unified Europe-wide single financial services regulator.<sup>67</sup> BaFin facilitates interaction with Germany's regulators and the other EU regulators. At the same time, BaFin regulates institutions more equitably within Germany and throughout Europe than its predecessor framework. Conglomerate regulations are more comprehensive and the costs of regulations were expected to fall under this arrangement. BaFin helped Germany to interface with creation of the European Central Bank.<sup>68</sup> BaFin seems to have met most of its pre-establishment goals.

Germany has a state system of banking institutions, but their supervision takes place on the federal level similar to FDIC-insured state banks in the United States. This system consists of private as well as state-owned banks. Banks are also owned by cities as well as other governmental entities. Some insurance as well as securities activities are supervised on the state level. Even though BaFin is required to supervise financial services firms, the Bundesbank maintains its responsibilities to continuously monitor the financial services sector.<sup>69</sup> To date, most analysts consider BaFin to be successful in regulating financial services firms in its all-in-one framework.<sup>70</sup>

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<sup>66</sup> For more detailed information about the Financial Supervisory Authority go to [[http://www.bafin.de/cgi-bin/bafin.pl?sprache=1&verz=01\\_\\$\\$bout\\_us\\*01\\_\\$\\$asks\\_and\\_Objectives&nofr=1&site=0&filter=&ntick=0](http://www.bafin.de/cgi-bin/bafin.pl?sprache=1&verz=01_$$bout_us*01_$$asks_and_Objectives&nofr=1&site=0&filter=&ntick=0)].

<sup>67</sup> See CRS Report RL32354, *European Union — United States: Financial Services Action Plan's Regulatory Reform Issues*, by Walter W. Eubanks.

<sup>68</sup> Ibid.

<sup>69</sup> Government Accountability Office, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO Report GAO-05-61, October 6, 2004, pp. 67-68.

<sup>70</sup> International Monetary Fund, *Germany — 2003 Article IV Consultation Concluding Statement of the Mission*, IMF, country Report no. 3/48, July 14, 2003, p. 5, [<http://www.imf.org/external/np/ms/2003/071403.htm>].

## U.S. Regulators Are Trying to Speak with One Voice

A consolidated financial services regulator at the national level in the United States would better accommodate negotiations and implementation of international regulatory agreements such as Basel II. In the Basel II negotiations, while all the major banking regulators participated, they disagreed on specific aspects of the negotiations (Basel II sets a more comprehensive framework for judging and containing bank portfolio risks and capital adequacy than Basel I, the current system being used in most industrial countries. Basel II should be more easily fine-tuned to react to changes in risks that affect bank capital). Overall recently, all indications are that the banking regulators are now in agreement on Basel II, even though they do not always speak with one voice.<sup>71</sup> On April 1, 2008, 11 large banks were to begin submitting Basel II implementation plans to their primary regulator, despite the fact the FDIC remained concerned about the internal models the banks are expected to use to determine the level of risk-based capital they are required to hold.<sup>72</sup>

### Some Implications

The United States' functional and competitive regulatory structure has been effective primarily because of its ability to address deficiencies in financial institutions' management of risk wherever they may appear. While doing this, the structure promotes economic growth by encouraging innovation, competition, and risk taking in the financial services markets. In addition, this structure is able to maintain its flexibility, and resiliency. On the other hand, the federal regulatory structure is replete with costly redundancies that proponents call checks and balances, but opponents call needless duplication. All regulators in this structure write rules, conduct off-site monitoring, and examine financial services firms for compliance with their rules and regulations. Proponents also argue that the costs of these duplicated activities are affordable due to the benefits the stable financial services industry contributes to overall economic growth.

While Congress has heard the arguments promoting consolidation of U.S. financial services regulators at the federal level, Congress has not enacted legislation to bring this about. The industry and its regulators have argued against creating a monolithic regulator, because it could lead to unchecked extension of regulation beyond the established jurisdictional boundaries. A consolidated regulator would alter the existing regulatory checks and balances. If such a consolidated regulator extended its regulatory powers, it could stifle innovation in financial services and prevent firms from shopping for regulators that provide the greatest advantage to

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<sup>71</sup> R. Christian Bruce, "Agencies Spar Over Capital Requirements as Discord Persists on Basel II Agreement," *BNA Banking Report*, May 16, 2005. p. 1, [http://ippubs.bna.com/IP/BNA/bar.nsf/SearchAllView/09D20CE5C743FB1F85257001000A97AE?Open&highlight=BASEL,II].

<sup>72</sup> See CRS Report RL34485, *Basel II in the United States: Progress toward a Workable Framework*, by Walter W. Eubanks and See U.S. Congress Senate Committee on Banking, Housing and Urban Affairs, *The Interagency Proposal Regarding The Basel Capital Accord*, hearing, 110<sup>th</sup> Cong., 1<sup>st</sup> sess., September 26, 2006, Available at [http://banking.senate.gov/public/\_files/ACF4A63.pdf].

their business plans. On the other hand, shopping for regulators could undermine safety and soundness by allowing the least effective regulator to supervise an increasing number of financial services institutions.

Evidence from the experience in the other industrialized nations that have consolidated their financial services regulatory structures suggests that a single regulatory structure could watch for systemic risk more effectively, but that evidence is inconclusive. These nations have not had these new regulatory structures in place for a long time, making it difficult to draw conclusions from their experience with any certainty. Moreover, these nations continue to experience failures at rates not significantly different from before their consolidation took place