Looking for the Silver Lining: Regulatory Reform After the "Credit Crunch"
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Looking for the Silver Lining: Regulatory Reform After the "Credit Crunch"

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Abstract

This Article examines the prospect for regulatory reform in the wake of the current crisis in the financial markets. This Article analyzes the supervisory framework for regulating financial services in the United States and the United Kingdom to highlight the different approaches in place before and during the crisis. The Article suggests that both sets of regulators evidenced a general failure in oversight, one that would likely have occurred irrespective of the particular framework in place. In light of the actions that have since been taken by government authorities to manage the market crisis (e.g. the various bailouts, the Troubled Asset Relief Program, and Federal Reserve open market operations to increase liquidity in the market), the Article puts forward a proposal for a new regulatory framework to oversee financial services in the United States, placing at its core the main economic and policy rationales for regulation and taking into account the shape of the regulatory landscape emerging from the current crisis.

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Abstract 314
Introduction 316
I. The Basis for Regulation 318
A. Some Reasons for Regulation 318
B. Managing Externalities 319
C. Ensuring Consumer Protection 321
D. Preventing Distortions of Competition 322
II. The Current Regulatory Framework 323
A. Overview of the Current U.S. Regulatory Framework 323
B. Overview of the Regulatory Framework in the U.K. 327
III. Reacting to the Crisis 332
A. Northern Rock 334
B. Lehman Brothers and AIG 340
IV. Crisis and Consolidation 350
A.Proposals for Reform 351
B. Towards a New Regulatory Framework 358
i. Regulating Systemic Risk and Managing Rescues 359
ii. The Key Actors in Rescues 361
iii. The Role of the States 364
iv. Allocations of Supervisory and Regulatory Responsibilities 366
a. Regulation of financial stability and monetary policy 368
b. Market conduct: 369
c. Consumer protection: 370
V. Consolidation - Points to Consider 371
VI. Conclusion 373

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Introduction

The current turmoil in the financial markets may fairly be described as historic. Widely likened to the Great Depression in its catastrophic potential,[1] the crisis offers a unique opportunity for a critical evaluation of the financial regulatory framework under which the present situation has come to pass, and, more particularly, for furthering a deeper and more far-reaching reform agenda than may otherwise have been possible.[2] While the trigger for this crisis can be attributed to the downturn affecting the housing market in the United States (U.S.), its spread to other world economies through the operation of globalized financial institutions and investment products has provided insight into the comparative workings of national regulatory systems and the lapses that may have occurred in the lead-up to and course of the crisis.

This Article examines the regulatory models of the U.S. and the United Kingdom (U.K.), with a view to comparing their designs and the relative performance of the two systems in weathering the current market storm. The U.S. and the U.K. provide a useful contrast. While sharing the common law tradition and espousing a laissez-faire market ideology shaped by this legal culture, the U.S. and the U.K. have diverged sharply in the construction of their respective financial regulatory frameworks.[3] As the U.K. has moved towards deeper consolidation in financial services oversight under a single regulator—the Financial Services Authority (FSA) —the U.S. has continued in its vehement adherence to a fragmented network of functional regulators at both the state and federal level. Notwithstanding this divergence, many of the regulatory challenges faced by both countries are common, in view of the globalized nature of market players' products, clients and investment strategies, and each country's desire to be seen as occupying a leadership position at the forefront of global financial centers.[4]

This Article analyses the structure of the U.K. and the U.S.

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[1] Jon Hilsenrath, Serena Ng & Damian Palletta, *Worst Crisis Since the Great Depression*, WALL ST. J., Sept. 18, 2008; *see also* HAROLD JAMES, THE CREATION AND DESRUCTION OF VALUE: THE GLOBALIZATION CYCLE 36-37 (2009); Ben Bernanke, Financial Reform to Address Systemic Risk, Speech to the Council on Foreign Relations (Mar. 10, 2009) (text available online at: http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm).

[2] David A. Skeel, Jr., *Governance in the Ruins*, 122 HARV. L. REV. 696, 741, 742 (2008) (reviewing CURTIS J. MILHAUPT & KATHARINA PISTOR, LAW AND CAPITALISM: WHAT CORPORATE CRISES REVEAL ABOUT LEGAL SYSTEMS AND ECONOMIC DEVELOPMENT AROUND THE WORLD (2008)).

[3] Howell Jackson, *An American Perspective on the U.K. Financial Services Authority: Politics, Goals & Regulatory Intensity* 3 (Harvard Law & Econ. Discussion Paper No. 522, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=839284.

[4] *See generally* THE FINANCIAL SERVICES ROUNDTABLE, THE BLUEPRINT FOR U.S. FINANCIAL COMPETITIVENESS (2007).

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regulatory frameworks in the context of some of the key rationales for regulating the financial markets. Looking into the crisis, the Article focuses on whether one or the other model may have been structurally better equipped to foresee and forestall the crisis. In the context of future reform, the Article seeks to examine the response of regulatory authorities to the crisis and the remedial actions that have been taken to revive financial institutions from their various instances of failure, with a view to suggesting the possible course that reform may take in light of these actions.

In this regard, this Article argues that the current crisis has demonstrated a general failure of regulatory oversight, one that would have occurred irrespective of the regulatory model in place. While the U.K. worked under a consolidated regulatory structure, criticisms regarding its conduct at several stages of the crisis (most notably with respect to the failure of Northern Rock) point towards a failure to make the most of the advantages that full-picture supervision offered. Similarly, the plethora of regulators in the U.S. failed to benefit from the operation of multiple supervisory eyes over the financial institutions under their watch. The Article goes on to suggest that the conduct of the U.S. Treasury (Treasury) and the Federal Reserve (Fed) in managing the bailout in the U.S. may have catalyzed a move towards more consolidated oversight. In this context, any future model must account for the crisis management role played by the Treasury and, more significantly, the Fed, within the normative rules of a revised supervisory and regulatory framework. Finally, the Article sounds a cautionary note on the consolidated model as a panacea for instances of regulatory ill-health.

Part I of this Article sets out an overview of the key rationales for regulation, with Part II analyzing the structure of the two regulatory systems in the U.S. and the U.K. in the context of these rationales. Part III examines instances of regulatory lapses on both sides of the Atlantic to consider the comparative workings of the U.S. and U.K. regulatory models before and during the crisis. Part IV analyses the potential for a move towards greater consolidation within the U.S. regulatory framework, taking into account the behavior of the Treasury and the Fed (as well as other U.S. agencies more peripherally) in reacting to the crisis, together with a suggested design for a revised U.S. regulatory framework. Part V sets out a critical discussion of the consolidated regulatory model, with some concluding remarks provided in the final part of this Article.

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I. The Basis for Regulation

A. Some Reasons for Regulation

It has been widely noted that incidences of financial crisis provide pause for thought, bringing to the fore the bad behavior of market players and offering an opportunity to re-evaluate the design of existing regulation for cracks in oversight.[5] More particularly, market trauma, in addition to highlighting such deficiencies, is useful in giving regulators perspective on how current rules can be said to reflect the underlying rationales for regulation in the first instance, and further, in making possible far-reaching reform that may otherwise be politically unpalatable. [6]

Although this Part sets out the general rationales for regulating the financial markets, a number of commentators have been skeptical of the broader role of regulation in maintaining the health of the financial markets. Indeed, economists like Dowd[7] and Bentson and Kaufman[8] have gone as far as to attribute the causes of crisis to the indirect effects of well-meaning regulation. In the context of the free market, regulation has been criticized as undermining the incentives that could be exercised by market players to control their own behavior, checked by client demand and oversight. In this regard, it has been argued that regulation stunts the self-regulatory impulse by fostering expectations that authorities should step in to control for sub-optimal behavior, while regulators themselves may be logistically unable to do so in every case. It has been suggested that regulation may sometimes be blamed for distorting market outcomes by imposing one-size-fits-all rules.[9] Other critiques of regulation focus on the excessive compliance costs that may, in any event, be insufficient to cover all of the risks generated from market participation, or on the view that market failure does not happen at all and to the extent that problems exist, regulation may be a costly and ineffective remedy to address market difficulty.[10]

Notwithstanding the above, there is widespread agreement that regulation is

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[5] CHARLES GOODHART ET AL., FINANCIAL REGULATION: WHY, HOW, AND WHERE NOW? 2 (1998).

[6] MARKUS BRUNNERMEIER ET AL., THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION 1 (International Center for Monetary and Policy Studies (preliminary conference draft)) (Jan. 24, 2009).

[7] Kevin Dowd, *The Case for Financial Laissez-Faire*, 106 ECON. J. 679 (1996).

[8] George Bentson & George Kaufman, *The Appropriate Role of Bank Regulation*, 106 ECON. J. 688 (1996).

[9] GOODHART, *supra* note 5.

[10] *See* DAVID LLEWELLYN, FINANCIAL SERVICES AUTHORITY, THE ECONOMIC RATIONALE FOR REGULATION 7 (1999).

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required to avoid or otherwise mitigate the effects of the crises that strike the financial system from time to time.[11] Although popular sentiment additionally creates pressures for controlling the conduct of financial institutions,[12] economists have highlighted that individual institutions, pursuing their own good, or even their perception of the common good, may be unable to understand the full-effect of their actions, resulting in the so-called "tragedy of the commons."[13] In this respect, it cannot simply be assumed that ensuring the soundness of single institutions can, without more, lead to the well-being of the market as a whole. As detailed below, single institutions, or even constituencies of institutions acting together, may not have the logistical or institutional capacity to manage risks arising out of externalities that have the potential not only to impact discrete groups of financial institutions, but also to spill out into the economy more broadly.

In view of the above, the following rationales have been put forward as underpinning the requirement for regulation:[14] Managing externalities, notably systemic and liquidity risks; ensuring consumer protection, including transparency in the provision of proper information to the market; and preventing distortions of competition. Each of these reasons is discussed in further detail below.

B. Managing Externalities

Regulation of externalities may be justified where the social costs of market failure exceed the private costs of such failure and the costs of regulation.[15] Commentators have argued that this constitutes the most important basis for regulation,[16] given the general inability of individual firms to control for such risks independently, and moreover for the potentially catastrophic impact of such events on the life-cycle of market players as well as on the economy as a whole. Externalities can give rise to the creation of systemic risks as well as risks to the flow of liquidity in the market.

Systemic risk may arise as a result of (i) a shock event impacting a number of firms; or (ii) a chain reaction from one failure with the potential to cascade outwards

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[11] *Id.; see also* GOODHART, *supra* note 5; LLEWELLYN, *supra* note 10, at 9.

[12] GOODHART, *supra* note 5, at 4.

[13] BRUNNERMEIER, *supra* note 6, at vii. In this study, the economists have noted that this may be exemplified in cases where one bank sells an asset when the price of its risk increases. Other banks can act similarly, eventually leading to the price of that asset falling, such that regulator action may be required to rectify the consequences from falling asset prices.

[14] *Id.* at 2.

[15] LLEWELLYN, *supra* note 10, at 13.

[16] BRUNNERMEIER, *supra* note 6, at 3.

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to other firms and more widely into the economy.[17] Commentators have noted the following types of externality that can give rise to systemic risks:[18] First, the spread of rumor and financial innuendo through the market can create the perception that difficulties affecting one firm pervade other similarly situated institutions, prompting sudden investor and creditor flight. A common consequence, affecting not just one but several institutions through contagion, is that firms are rapidly drained of liquidity, making their assets vulnerable to fire-sales in an effort to maintain some operational funding.

Second, once an institution fails, its customers may find themselves at something of a loss, facing the possibility that information about their credit and investment histories has not been adequately communicated to remaining institutions, making it more expensive for them to gain access to the market, particularly if it is already risk-averse in the aftermath of crisis.

Third, modern financial systems demonstrate high degrees of interconnectedness through a number of factors, including, but not limited to, the operation of secondary markets where firms are linked by contract, mutual risk-management measures (e.g. credit default swaps (CDS)),[19] the payments system,[20] inter-bank lending, and through clearing and settlement systems. This interconnectedness arguably increases the risk of contagion by providing mechanisms for transmission of risk and multiplying the degree of market vulnerability in cases where risk can spread through numerous connections at the same time (e.g. through contractual obligations in the secondary market, through inter-bank lending, and through risk-mitigation mechanisms entered into between firms).

Fourth, the interconnectedness can give rise to self-amplifying negative spirals that may further weaken the economy without intervention. By way of example, a fall in asset prices can hit a bank's balance sheet, prompting a run on the bank and possibly others, further diminishing the value of assets in the rush to generate liquidity through fire-sales of assets. Where firms hold similar types of assets, the fall in market value will impact the economy as a whole and throw a number of firms into the same state of crisis as the originally troubled institution(s).

Fifth, afflictions affecting financial institutions are likely to eventually creep into a general economic slowdown where firms become reluctant to extend credit to

[17] HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATIONS 9 (16th ed. 2009).

[18] BRUNNERMEIER, *supra* note 6, at 2-4.

[19] SCOTT, *supra* note 17, at 10.

[20] *Id.* at 11.

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consumers and businesses or otherwise make access to funds prohibitively expensive, limiting purchasing power, business output, and re-financing options for meeting on-going obligations.

Related to the notion of systemic risk, regulation may be necessary to ensure that constrictions in liquidity are not permitted to increase the negative impact of the various externalities set out above. In this regard, regulation may be warranted to ensure that firms' expectation of liquidity can broadly tally with the flow of liquidity in the market following a crisis event. Further, it has been argued that firms that do nevertheless work to keep a liquidity cushion for the proverbial rainy day may incorrectly estimate the level required, particularly when other firms keep similar cushions,[21] increasing the likelihood of market-wide sell-offs to meet spiking demands for funds.

C. Ensuring Consumer Protection

Regulation can also provide a base level of consumer protection. Controlling the flow of information between different sectors of the market, allowing key data to reach investors and the public more widely, forms one part of this objective. In this context, firms come under a duty to make sufficient data available for investors to make proper investment decisions. Given that investors may not have the individual resources to undertake laborious and expensive investigations into the health and prospect of firms, disclosure obligations may be especially important to ensure that investment funds are properly allocated to deserving market players.[22] The effect of information asymmetries is all the more troubling for unsophisticated investors who are likely to suffer more acutely from difficulties in accessing good data about investments. Accordingly, regulation can be helpful in directing firms to ensure that their data is tailored to the relative sophistication of target investors and the market as a whole.

Calls for mandatory disclosure are also supported by the crucial fact that the price for securities is contingent on the future performance of the securities and cannot generally be gauged by factors that are easily observed at the time that the securities are purchased. Therefore, the policy rationale dictates that investors be provided with sufficient data to be in a position to evaluate the underlying characteristics of securities or issuer and to assess potential for upwards growth,

[21] Luigi Zingales, *The Future of Securities Regulation* 7-8 (Chicago Booth Sch. of Bus. Research Paper No. 08-27, FEEM Working Paper No. 7, 2009).

[22] Larry Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1, 10 (1992).

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especially given the possibility that an issuer may suffer moral hazard and behave opportunistically once the contract for purchase has been concluded. On a broader level, regulation to account for information asymmetry recognizes that stakeholders each possess a diverging set of information in relation to the market by virtue of the differing positions they occupy. Therefore gaps in information flow between market stakeholders may be seen to create economic costs where disparately held information fosters uncertainty, raising risk and consequently irrationally affecting incentives for market participation across the various constituencies of investors.

Within the overall rationale of consumer protection, the second prong of regulatory attack relates to the importance of rules that mitigate risks arising as a result of investors losing day-to-day control over their funds once these are handed over to an agent on their behalf—so called, "agency risks." Regulation may prevent unscrupulous agents from taking excessive risks with investors' funds, which would otherwise deter investors from accessing the markets or diminish the value of the securities traded as a result of the risk attached to them.[23] Regulation recognizes that investors and their agents may have conflicting interests, necessitating measures (e.g. monitoring by third parties such as lawyers or auditors) to ensure that agents are not drawn to the temptation of using other people's funds for short-term and inappropriate gain.[24]

D. Preventing Distortions of Competition

While traditionally employed in the regulation of large conglomerates and utilities, rules to prevent distortion of competition have recently also appeared in the area of financial services.[25] The requirement for regulation in this regard is two-fold. First, competition policy can ensure that the financial market remains open to new players that are able to meet objective and non-discriminatory entry criteria.[26] Accordingly, consumers may be given a greater choice of financial services providers, improving overall market efficiency as firms compete for custom. Second, where a single player controls a large financial network economy, such as a clearing house, competition regulation may be necessary to ensure that firms required to participate in such a network are not overcharged or otherwise unfairly treated as a

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[23] Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 339, 340 (2006).

[24] Stephen J. Choi, *A Framework for the Regulation of Securities Market Intermediaries*, 1 BERKELEY BUS. L.J. 45, 46 (2004) (observing that "through the expenditure of costly resources, any single investor may monitor and work to discipline underperforming managers," but that "no single investor will have full incentives to engage in such activities").

[25] BRUNNERMEIER, *supra* note 6, at 2.

[26] LLEWELLYN, *supra* note 10, at 49.

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result of the provider's monopoly position.[27]

II. The Current Regulatory Framework

Although the various rationales for regulation may be said to provide a common policy benchmark for regulators, the U.S. and the U.K. have diverged sharply in the creation of their regulatory institutional frameworks for the exercise of regulatory power. The reasons for this difference are manifold, rooted in the intricacies of politics, history, legislative design and legal culture.[28] The rationales themselves do not suggest an optimal regulatory design, permitting national particularities in the means through which regulatory objectives are achieved. Nevertheless, as discussed below, institutional design has a bearing on the division of responsibilities for oversight. Abstractly, such allocations can result in a fractured interpretation being given to the same regulatory objective through differences in agency culture, enforcement intensity, cost pressures and inter-agency coordination (and in-fighting), thereby impacting the optimal attainment of regulatory goals.

This section provides a summary of the U.S. and U.K. regulatory frameworks, with a brief overview of their advantages and areas of concern.

A. Overview of the Current U.S. Regulatory Framework

In 2006, Senator Schumer and Mayor Bloomberg offered a pessimistic account of the stifling influence of the U.S. regulatory framework on the competitive pull of New York as a leading financial services center versus other financial hubs, notably London, that operated under a more consolidated supervisory model.[29]

It has been estimated[30] that the U.S. has 115 regulatory agencies operating at

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[27] BRUNNERMEIER, *supra* note 6, at 2.

[28] Jackson, *supra* note 3. Professor Jackson provides a detailed discussion of the factors that may have contributed to the divergences between the institutional set-up of the U.K. and U.S. financial regulatory framework. For example, he distinguishes the parliamentary system in the U.K. that may have been more amenable to pushing through a radical reform agenda within a few short years, the influence of the European Union framework in mandating certain changes to financial services laws, suspicions in the U.S. of concentrated central government authority and local entrenchments on the part of U.S. regulators keen to preserve their power.

[29] SEN. CHARLES SCHUMER & MAYOR MICHAEL BLOOMBERG, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP, (January 2007) [hereinafter SCHUMER-BLOOMBERG REPORT]; Sen. Charles Schumer and Mayor Michael Bloomberg, *To Save New York, Learn from London,* WALL ST. J., Nov. 1, 2006, at A18.

[30] Elizabeth Brown, *E Pluribus Unum-Out of Many, One: Why the United States Needs a Single Financial Services Agency,* 14 U. MIAMI BUS. L. REV. 1, 28-39 (2005).

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the state and federal level in the financial services[31] sector, leaving firms with obligations to comply with a confluence of several legal regimes. By way of example, a bank operating under a national charter must comply with rules promulgated by the Fed, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). Where a bank is under state charter in the Federal Reserve system, it is required to comply with the rules and regulations mandated by the Fed and the FDIC, as well as such requirements stipulated by the state that chartered the bank.[32] Moreover, as appears to increasingly be the case,[33] firms are engaged in selling and investing in a variety of financial products that are not restricted to discrete regulatory categories (e.g. banking, securities or insurance), and regulatory obligations to various state and federal agencies increase accordingly. A firm that is engaged in banking, securities, and insurance business, or offering products that overlap within these categories (e.g. certain types of annuities) may find itself being supervised by the Fed, the FDIC, the OCC, the Office of Thrift Supervision (OTS), the Securities and Exchange Commission (SEC), the Commodities and Futures Trading Commission (CFTC), the Securities Investor Protection Corporation (SIPC), the National Credit Union Administration (NCUA), and the Pension Benefit Guaranty Corporation (PBGC), together with relevant banking, securities and insurance regulators at the state level. In addition to opening firms up to a proliferation of supervisory regimes, the mechanisms for enforcement vary across regulatory agency, and firms must therefore accommodate their compliance to a number of enforcement authorities and cultures. In this regard, enforcement for regulatory offences may take place through the functional regulators, the Department of Justice, and the Federal Trade Commission (FTC), as well as through private litigation.[34]

Further, industry representatives have noted the highly prescriptive nature of the rules governing conduct, with statutes such as the Gramm-Leach-Bliley Act,[35] the Patriot Act[36] and the Sarbanes-Oxley Act (SOX)[37] imposing detailed and sometimes overlapping rafts of rules, in addition to requirements under existing state laws (e.g. in the area of privacy).[38] As above, firms putting forward multi-category

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[31] In this article, the term "financial services" covers those services included within Section 103 of the Gramm-Leach-Bliley Act, Pub.L. 106-102, 113 Stat. 1338.

[32] Brown, *supra* note 30.

[33] THE FINANCIAL SERVICES ROUNDTABLE, *supra* note 4, at 17.

[34] *Id.*

[35] Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[36] Pub. L. No. 107-56, 115 Stat. 272 (2001).

[37] Pub. L. No. 107-204, 116 Stat. 745 (2002).

[38] THE FINANCIAL SERVICES ROUNDTABLE, *supra* note 4, at 17.

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product offerings may find themselves subject to a number of statutes, including but not limited to, the FDIC Act,[39] the Bank Holding Company Act of 1956,[40] the Bank Secrecy Act,[41] the Gramm-Leach-Bliley Act, the Real Estate Settlement Procedures Act,[42] Community Reinvestment Act,[43] the Patriot Act, the Sarbanes-Oxley Act, and federal insurance statutes, such as the Terrorist Risk Insurance Act of 2002.[44] [45] Accordingly, it has been argued (for example, by the Schumer-Bloomberg Report) that the plethora of regulators has led to an excess of prescription, together with the duplication and inefficiencies that this potentially fosters, and it has made the U.S. and its financial centers unattractive for foreign firms, or even for local businesses that may be tempted to consider establishing abroad under more approachable and less legally burdensome regulatory regimes.[46]

At the agency level, the supervisory fragmentation has not been accompanied by close coordination between authorities to minimize duplications and inefficiencies. While some effort has been made in this regard,[47] for the most part inter-agency cooperation has been minimal, with no meaningful, formal forum in operation to bring regulators together. Indeed, the multiplicity of bodies has fostered inter-agency competition,[48] easily translating to turf conflict,[49] with the potential to undermine appropriate disclosure, information sharing, systemic risk assessments, and the development of a holistic understanding of market mechanisms and products.

Consequently, even before the crisis, calls for reform were widespread.[50] In addition to efforts by Senator Schumer and Mayor Bloomberg, the Treasury's 2008 proposal for regulatory reform, the *Blueprint for a Modernized Regulatory Structure*[51]

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[39] Pub. L. No. 101-73, 103 Stat. 187, 256 (1989).

[40] Pub. L. No. 511, 70 Stat. 133 (1956).

[41] Pub. L. No. 91-508, Title I, 84 Stat. 1114 (1970).

[42] Pub. L. No. 93-533, 88 Stat. 1724 (1974).

[43] Pub. L. No. 95-128, 91 Stat. 1147 (1977).

[44] Pub. L. 107-297, 116 Stat. 2322 (2002).

[45] THE FINANCIAL SERVICES ROUNDTABLE, *supra* note 4, at 17.

[46] *Id.* at 44.

[47] For example, joint regulations made by federal banking regulators.

[48] *International Banking: Cycle Clips*, THE ECONOMIST, May 15, 2008; *Will it Fly?*, THE ECONOMIST, April 3, 2008.

[49] Elizabeth Brown, *the Tyranny Of The Multitude is a Multiplied Tyranny: Is the United States' Financial Regulatory Structure Undermining U.S. Competitiveness?*, 2 BROOK. J. FIN. & CORP. L. 369, 378, 379 (2008).

[50] Brown, *supra* note 30.

[51] U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008) [hereinafter U.S. TREASURY, BLUEPRINT].

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("Blueprint") sought to build the institutional weight of opinion in favor of consolidating the regulatory architecture and moving towards more principles-based, rather than prescription-heavy, supervision. Indeed, tentative steps have been taken to incorporate some principles-based regulation into the current framework. For example, the CFTC has moved towards a principles-based supervisory regime for the regulation of the futures industry further to the enactment of the Commodity Futures Modernization Act of 2000.[52] Under the regime, U.S. futures exchanges are now required to demonstrate compliance with 18 core principles in the conduct of their market operations to retain their regulatory status. The principles-based approach has been promoted as a means of providing that regulatory outcomes can keep pace with and be interpreted to conform with evolving technology and industry standards. [53] Additionally, the President's Working Group on Financial Markets ("PWG") adopted a principles-based approach for guiding treatment of private pools of capital, e.g. in relation to hedge funds.[54] However, such initiatives remain discrete for the time being and look likely to face some post-crisis opposition in the years ahead, in favor of harder-edged regulation to safeguard against any perception of regulatory flexibility for firms.

The complexities of the current framework have arguably created a set of obstacles to reform. First, the integration of regulatory authority into a more consolidated framework will require not just a bringing together of institutions and personnel but also an alignment of the regulatory cultures within the various agencies involved. With the large number of agencies operating at just the federal level, spanning those embedded within the Treasury (the OCC and the OTS) as well as the independent Fed, the spread of regulatory cultures is, at present, considerable. Moreover, divergent enforcement mechanisms may require further reconciliation to even out the level of regulatory intensity deployed by different agencies into an institutionally consistent approach. In this context, reform will also require to address the role of private litigation in checking firms' conduct (e.g. in the area of securities law). This may prove especially intractable given the culturally deep-rooted role of class action lawsuits and aggressive private litigation in the policing of market behavior.[55] Determining how to allocate liability risks within any revised

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[52] Pub. L 106-554, 114, Stat 2763 (2001).

[53] Walter Lukken, Walk Softly and Carry a Big Stick, Speech at ISDA Energy, Commodities and Developing Products Conference (Nov. 29, 2007).

[54] Press Release, U.S. Treasury, President's Working Group Releases Common Approach to Private Pools of Capital: Guidance on Hedge Fund Issues Focuses on Systemic Risk, Investor Protection (Feb. 22, 2007).

[55] Jackson, *supra* note 3, at 9.

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framework may set high political hurdles in the path of reform. Finally, consolidation within the regulatory network may require transparency in the statement of regulatory priorities, notably with regard to specification in the relative weight given to regulatory objectives. In view of the plethora of agencies, each of which may be sectorally focused and concentrated on achieving particular objectives,[56] consolidation will require a working out of how these are balanced within a more unitary framework.

B. Overview of the Regulatory Framework in the U.K.

Prior to 2001, the regulatory framework in the U.K. for supervision of financial services had been fragmented along sector-specific lines.[57] A number of separate and independent bodies operated to regulate building societies, friendly societies, and securities and futures businesses. In June 1998, responsibility for banking supervision was transferred from the Bank of England to the FSA, and in 2000, the FSA began to supervise stock exchange listing, taking over from the London Stock Exchange. Following the enactment of the Financial Services and Markets Act of 2000 (FSMA) that came into force in 2001, the FSA became the consolidated supervisor of financial services, taking over responsibilities from the various regulatory agencies mentioned above. In 2004 and 2005, the FSA additionally took over supervision of mortgage regulation and general insurance business, respectively.[58]

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[56] In some cases, one agency is working towards the achievement of more than one regulatory objective, as set out in Part 1. For example, the Fed, as the central bank and promulgator of monetary policy, may be seen as the front-line in the management of systemic and liquidity risks. However, the Fed has also been given a role in consumer protection, for example, in the application of the Truth in Lending Act. Further, as bank supervisor, it takes a role in monitoring the implementation of the socially redistributive Community Reinvestment Act. Also, the SEC may be seen as directing its activities in the protection of investors by enforcing disclosure rules as well as mitigating agency risks arising (e.g., under SOX), while playing an important role in overseeing systemic build-up of risk in its duties as supervisor of trading floors such as the New York Stock Exchange or electronic platforms such as NASDAQ.

[57] Prior to reform under the FSMA, responsibility for regulation was divided principally between the following organizations: (i) Building Societies Commission; (ii) Friendly Societies Commission; (iii) Investment Management Regulatory Organization; (iv) Personal Investment Authority; (v) Register of Friendly Societies; and (vi) Securities and Futures Authority. In preparation for transfer of eventual regulatory authority, the Chancellor created the Securities and Investment Board in 1997 to conduct broad oversight before eventually taking over full regulatory responsibilities going forward. The SIB changed its name to the FSA in October 1997. Financial Services Authority, *About the FSA: Who Are We?*, *available at* http://www.fsa.gov.uk/Pages/About/Who/History/index.shtml.

[58] *Id.*

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FSMA requires the FSA to give effect to the following statutory objectives: (i) to maintain confidence in the financial system; (ii) to promote public understanding of the regulatory system; (iii) to secure the appropriate level of protection for consumers; and (iv) to reduce financial crime.[59] There had been some debate in the course of their formulation as to whether FSMA should additionally require the FSA to minimize the anti-competitive effects of requirements placed on authorized persons by the FSA.'[60] However, instead of codifying such an objective, the FSA's rule-making in the area of competition law is overseen by the U.K.'s Competition Commission and the Director General of Fair Trading, with both bodies entitled to conduct the first review of relevant legislation and to recommend changes if required. In general, the FSA's mandate on competition is limited to ensuring that the FSA minimizes the adverse effects on competition in the exercise of its functions and that it note the desirability of promoting competition in financial services.[61]

Following the enactment of FSMA, the U.K.'s regulatory model has sought to gradually reflect a broadly principles-based regime, guided by a set of eleven high-level principles[62] that overlie the detailed rules set out in the FSA Handbook[63] for regulating financial services (e.g., in relation to prudential requirements or conduct of business rules).[64] The U.K.'s regulatory framework is not exclusively principles-based, but rather blends detailed rules within a normative regulatory context underpinned by the eleven core principles. Accordingly, notwithstanding firms' obligation to comply with relevant FSA Handbook rules, the FSA has historically looked to distance its enforcement strategies from a simple "box ticking" approach,[65]

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[59] Financial Services Authority, *About the FSA: Statutory Objectives, available at* http://www.fsa.gov.uk/pages/About/Aims/Statutory/index.shtml.

[60] DON CRUICKSHANK, COMPETITION AND REGULATION: AN INTERIM REPORT, REVIEW OF UK BANKING SERVICES (July 24, 1999).

[61] Clive Briault, *Revisiting the Rationale for a Single National Financial Services Regulator* 10-11 (FSA Occasional Papers in Fin. Reg., Series No. 16, Feb., 2002).

[62] Financial Services Authority, FSA HANDBOOK, Princ. 2.1, available at: http://fsahandbook.info/FSA/html/handbook/PRIN/2/1.

[63] The FSA Handbook is the regulatory manual setting out rules and guidance for authorized firms under the supervision of the FSA. The Handbook comprises a number of volumes applicable to different types of businesses (e.g. insurers, regulated investment exchanges) as well as rules that are to be applied to authorized firms in general, for example in relation to their organizational structure, conduct of business, and internal systems and controls. The Handbook seeks therefore to provide a comprehensive manual for the regulation of financial services firms in the U.K., although the FSA regularly issues guideline and explanatory documents to provide guidance in the interpretation of Handbook provisions.

[64] FSA, PRINCIPLES BASED REGULATION: FOCUSING ON THE OUTCOMES THAT MATTER (Apr., 2007).

[65] CALLUM MCCARTHY, PRINCIPLES-BASED REGULATION—WHAT DOES IT MEAN FOR THE INDUSTRY? (Fin. Servs. Skills Council 2nd Annual Conference, Oct. 31, 2006).

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and indeed a number of its most prominent enforcement actions have been taken for breaches of principle, rather than rules.[66] In so doing, the FSA has been seen to adhere to what may be termed a more holistic approach, taking into account specific rule breaches, but in addition analyzing how such breaches relate to the observance and maintenance of its eleven core principles. However, reacting to the criticism it has faced for its handling of the crisis (as detailed below) and the U.K's now-maligned "light touch" approach to oversight,[67] the FSA has recently sought to promote a harder, "outcomes-based" supervisory philosophy, one that maintains the centrality of the eleven principles, but aims to implement their tenets with a toughened touch.[68]

Internally, the FSA has sought to combine the single regulator model with a professed broader commitment to supervise in accordance with an integrated legal framework. For an international financial center, the single regulator model was seen as best placed to address the issues arising from an increasingly global, interconnected market for financial services, bringing together different types of financial products, institutions and market-mechanisms, such that a fragmented regulatory framework was perceived as being unable to exercise optimal and effective oversight of the system and its parts. [69] It has been argued that, by having oversight across the range of financial services firms, the single regulator could be permitted a unique, unbroken perspective into the types of financial products and services being offered, the inter-links and dependencies between market players, and

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[66] For example, the FSA's enforcement actions against Citigroup for GBP 13.9 million for its trading practices in the European government bond markets. Citigroup used multi-lateral trading systems (MTS), electronic trading platforms, for performing as many trades in government bonds as it could in a period of 18 seconds. This behavior was deemed to constitute a breach of Prin 2.1. Jill Treanor, *Watchdog Fines Citigroup 14m*, GUARDIAN, June 29, 2005. More recently, the FSA fined Deutsche Bank approximately GBP 6.3 million for carrying out proprietary trading during a book-building exercise that it was conducting. In this case, the FSA determined that Deutsche had breached the principle to carry out its business observing proper standards of market conduct and using due care and skill. Press Release, FSA, FSA Fines Deutsche Bank £6.3million and Mr. David Maslen £350,000 for Market Misconduct (April 11, 2006), *available at* http://www.fsa.gov.uk/pages/Library/Communication/PR/ 2006/036.shtml.

[67] Peter Koenig, *Financial Crisis: Light Touch Regulation Failed to Control the Markets*, THE TELEGRAPH (Sept. 27, 2008), *available at* http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3093523/Financial-crisis-Light-touch-regulation-failed-to-control-the-markets.html.

[68] Hector Sants, Intensive Supervision: Delivering the Best Outcomes, Speech delivered at Bloomberg (Nov. 9, 2009), *available at* http://www.fsa.gov.uk/pages/Library/ Communication/Speeches/2009/1109_hs.shtml.

[69] Eilis Ferran, *Examining the United Kingdom's Experience in Adopting the Single Regulator Model*, 28 BROOK. J. INT'L L. 257, 258 (2003).

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the systemic, infrastructural vulnerabilities affecting both regulated firms and their customers.

Within the organization of the FSA, supervisory responsibility is undertaken by a number of divisions, such that units within the FSA have established specific sectoral expertise in relation to firms' regulated conduct (e.g. banking, insurance, investment firms and markets and exchanges).[70] That being said, the FSA is organized so that the largest and most complex firms are supervised by a single division bringing together the expertise of the various sectors into one supervisory team. In the case of other firms, it is understood that each firm is allocated a team that includes representatives from different sectors, although supervision is primarily divided along sector-specific lines.[71]

Notwithstanding the above, it is worth noting that while the U.K. is considered as espousing a single-regulator model,[72] supervising prudential as well as conduct of business rules, regulatory power is divided among a tripartite arrangement of the FSA (overseeing individual firms), HM Treasury (the U.K. government body generally tasked with drawing up rules and initiating the drafting of legislation), and the Bank of England (once the banking supervisor in the U.K. but now the overseer of financial stability and monetary policy).[73] While the FSA may be seen to stand on the frontline of supervision, interaction between the FSA, the Bank of England, and the Treasury is formalized under a Memorandum of Understanding[74] setting out the spheres of responsibility for each body.[75] The Memorandum provides for the fulfillment of four key objectives: (i) accountability for each member of the committee and therefore a delimited sphere of responsibility; (ii) transparency in ensuring that stakeholders and the public understand the division of responsibility; (iii) avoidance of duplication; and (iv) information exchange.

The U.K. model, while neither strictly principles-based nor single -regulator, has provided an impetus for a regulatory shift in numerous other jurisdictions,

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[70] FSA, *Supervision Business Unit*, *available at* http://www.fsa.gov.uk/Pages/About/Who/Management/Retail/index.shtml.

[71] Briault, *supra* note 61, at 18.

[72] Brown, *supra* note 30, at 28-39.

[73] William Buiter, *Lessons from Northern Rock: How to Handle Failure*, VOX, March 5, 2008, *available at* http://www.voxeu.org/index.php?q=node/964.

[74] As discussed later in this paper, the passage of the Banking Act of 2009 sets out measures for the interaction of the three bodies in relation to the rescue of failing financial institutions.

[75] Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority, FSA-Bank of England-HM Treasury (Mar. 2006), *available at*: http://www.fsa.gov.uk/pubs/mou/fsa_hmt_boe.pdf.

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including Germany, Japan, and Korea, towards a more unitary regulatory framework. [76] It has also been widely cited in the *Blueprint* as providing an illustration of a regulatory system that has successfully transitioned from a sectoral to a single-regulator framework.[77] By contrast, commentators have noted that the U.S. regulatory framework is not being used as an example for other jurisdictions to follow, with the general global trend reflecting a preference for a more consolidated design.[78]

From the perspective of industry, the Bloomberg-Schumer report suggested that many within the financial industry ranked the U.K.'s regulatory model as being superior to that of the U.S., with credit given to the regulatory simplicity of a unitary, principles-based regulator.[79] As set out above, commentators have also tended to draw attention to the suitability of a unitary approach in understanding the complexities of firms' businesses that often straddle jurisdictions and cannot be neatly categorized by sector.[80] The *Blueprint* noted that a single-regulator approach creates efficiencies and allows for the implementation of a clearer and more consistent regulatory strategy across the board, giving regulators a full-picture understanding of the risks affecting the financial sector as a whole.[81]

It has been suggested the legal and political particularities of the British system may have facilitated the move in the U.K. from sectoral to greater consolidation in regulation . The parliamentary system permitted the Labour government, with its large electoral majority, considerable control over the pace and direction of reform.[82] Alongside a relative cultural comfort with centralization in government and popular outrage at regulatory scandals seen as undermining the system (e.g. the near overnight failure of the venerable Barings Bank),[83] reformers were able to set out a conceptually radical yet otherwise procedurally piecemeal move towards consolidation without encountering significant opposition. Further, the continuous flow of European legislation emanating from Brussels, demanding as it did regulation across a number of financial sectors, and the economic prerogative to ensure that London remained the leading financial center in the region, may have

[76] Ferran, *supra* note 69, at 257.
[77] U.S. TREASURY, BLUEPRINT, *supra* note 51, at 8.
[78] Brown, *supra* note 49, at 372.
[79] SCHUMER-BLOOMBERG REPORT, *supra* note 29, at 89.
[80] Ferran, *supra* note 69.
[81] U.S. TREASURY, BLUEPRINT, *supra* note 51, at 141.
[82] Jackson, *supra* note 3, at 6
[83] *Id.* at 7, 12.

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additionally pushed the radical reform agenda.[84]

III. Reacting to the Crisis

The recent crisis in the financial markets has stretched regulatory resources and focused critical attention on the quality and effectiveness of the action taken by regulatory authorities in managing the fallout. With the opportunity to reflect on causes and the potential contribution of regulatory mechanisms to the crisis, it may be timely to consider how, if at all, the differing regulatory models described could be said to have provided greater or lesser protection to the markets and firms within their supervisory purview. Given the breadth and depth of the crisis, as well as the number of factors that have been at play in regulatory decision-making, an analysis of the place of the supervisory framework in fomenting, absorbing and controlling the spread of the crisis is necessarily speculative. However, the response of U.S. and U.K. regulators to the unfolding severity in the markets, as exemplified, *inter alia,* by the failure of Northern Rock and Lehman Brothers and the fall and rescue of the U.S. insurer, American International Group ("AIG") is instructive in comparing the operation of the different regulatory regimes described above, with a view to understanding the relative success of each in managing a distressed regulatory situation.

As set out above, the consolidated regulatory framework should have offered a comparative advantage to regulators in predicting the onset of and then being able to manage the crisis. First, with oversight over the prudential, trading, and conduct of firms' business operations, the FSA should have been institutionally permitted a meaningful understanding of the risk-profile of its charges and whether, broadly speaking, the activities being carried out by firms could be justified by the capital cushions held under applicable capital adequacy rules, as well as by the risk-relevant guidance given to them by the FSA.[85] Working within the principles-based framework, it is arguable that the purposive (rather than strictly legalistic) tenor of such an approach would have been useful in dealing with the knots of legally less visible risks that were developing through the widespread use of special purpose vehicles and off-balance sheet mechanisms implicated in high-risk investments within the secondary market. Second, in addition to having oversight over single firms, the FSA was afforded supervisory coverage over behavioral trends within the market as a whole, including the major exchanges and settlement systems.

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[84] *Id.* at 10-11.
[84] *Id.*
[85] Howard Davies, Capital Requirements and Crisis Prevention Policies, Speech given at the Banks and Systemic Risks Conference, Bank of England (May 25, 2001).

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While there may been a lack of transparency in the reporting of over-the-counter derivative products such as credit default swaps[86] that have since been accused of contributing to the skewed management of risk by firms, the scope of supervisory attention was considerable and, in theory, largely comprehensive.[87] Third, the regulatory architecture comprised only three bodies (as compared to the roughly 115 operating within the U.S.). Working with the Memorandum of Understanding that delimited spheres of authority between the Bank of England, the FSA, and the Treasury, the system should have been well-prepared to coordinate efforts to act in the event of trouble. As set out above, the division of responsibility includes a provision to deal with emergency situations,[88] such that action should have followed a pre-agreed course. Other advantages that could have put this consolidated model on a better footing for managing market trouble include a consistency in enforcement approaches backed by procedures for regular monitoring and dialogue with firms. Finally, the FSA, as an independent regulatory agency with rule-making authority under FSMA, enjoys considerable latitude in its conduct and—given its distance from the innards of government—should have been relatively insulated from political or other lobbying pressures that may have blurred its view over the market.

By contrast, it may be argued that the fragmented state of oversight in the U.S. could well have been an impediment in catching and subsequently managing the crisis. However, such an assessment may be unduly one-sided.

For one, the sectoral oversight exercised by various functional regulators could be said to have encouraged the operation of greater, more expert oversight in regulated areas. As the institutional progeny of the New Deal, many functional regulators have accumulated significant experience and knowledge in their area of supervision. By way of example, the SEC has been carrying out specialist supervision over the securities markets and securities firms since 1934, giving effect to the Securities Act of 1933[89] and the Securities Exchange Act of 1934,[90] as well as to more recent legislative provisions such as SOX.[91]

In addition, the overlapping jurisdiction of the numerous state and federal

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[86] *See* FSA QUARTERLY CONSULTATION (No. 18, Oct. 2008), *available at* http://www.fsa.gov.uk/pages/Library/Policy/CP/2008/08_16.shtml (proposing reforms to improve transparency in relation to trades in complex over-the- counter derivative products).

[87] Davies, *supra* note 85.

[88] *See* Memorandum of Understanding, *supra* note 75, ¶¶ 13–14.

[89] 15 U.S.C. § 77a (2006).

[90] 15 U.S.C. § 78a (2006).

[91] Securities and Exchange Commission, *What We Do: Creation of the SEC*, http://www.sec.gov/about/whatwedo.shtml#create.

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agencies (as detailed above), while leading to potential duplications, may well have conferred the advantage of several pairs of supervisory eyes overseeing the health of firms. Related to this, the vast numbers of personnel resources that U.S. regulatory authorities have at their disposal[92] could at least have provided the means for the exercise of thorough oversight. Moreover, notwithstanding the trend for principles-based oversight, reliance on rules (rather than on more teleological, interpretatively ambiguous principles) to govern the conduct of firms may have been useful in creating regulatory certainty for supervisors as well as for firms under their oversight, such that promulgation of the right rules could have resulted in positive regulatory outcomes.

Finally, the Fed presently enjoys considerable institutional independence within the regulatory network. Although accountable to Congress through Congress' inherent power to repeal or modify the Federal Reserve Act, the Fed may nevertheless be said to enjoy a high degree of independence from the political process, giving rise to insulation and relative leeway[93] to act in the furtherance of its objectives.[94] This independence, combined with the ability to generate its own source of funds, gives the Fed the institutional capacity to act decisively if needed in the management of crisis situations, with, or arguably without, the support of other regulators.

A. Northern Rock

The lines of Northern Rock depositors snaking through many main streets across the U.K. provided a vivid demonstration of regulatory crisis, and the response to it was seen as a serious test of the workability of the regulatory model exemplified by the FSA, Northern Rock's regulator.[95] In spite of the promise of cohesive, clear, and consolidated oversight, the conduct of the FSA and the tripartite committee in preventing the Northern Rock debacle, and in reacting to it subsequently, fell substantially short of expectations.[96]

The difficulties that eventually overcame Northern Rock had been a long

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92 Howell Jackson, *A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States*, (Harvard Public Law Working Paper No. 09-19, Nov. 12, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1300431.

93 JOINT ECONOMIC COMMITTEE, UNITED STATES CONGRESS, STUDY: TRANSPARENCY AND FEDERAL RESERVE MONETARY POLICY (Nov. 1997), *available at* http://www.house.gov/jec/fed/fed/transpar.htm.

94 *E.g.*, Federal Reserve Act, 12 U.S.C. ch. 3 § 2a.

95 Carlos Conceicao, *Rocking the Boat*, THE LAWYER, May 12, 2008.

96 FINANCIAL SERVICES AUTHORITY, EXECUTIVE SUMMARY OF THE INTERNAL AUDIT REPORT (Mar. 26, 2008), http://www.fsa.gov.uk/pubs/other/exec_summary.pdf.

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time in the making.[97] The bank had developed a business model that sought aggressive expansion of its retail mortgage business, relying on funding obtained in the secondary market through securitizations of the mortgage portfolios on its books. As a result, Northern Rock was particularly vulnerable to liquidity restrictions and interest-rate fluctuations in the secondary market, as took place during the "sub-prime" mortgage crisis. Further, by failing to buffer its capital reserves through an expansion of its deposit-taking business, Northern Rock was especially dependant on sources of funding from the secondary market that became increasingly scarce and expensive as the credit crisis deepened.[98]

The U.K.'s HM Treasury Select Committee's report on the failure of Northern Rock identified the bank's business model as being inherently risky and reckless.[99] The report also noted that the manner in which Northern Rock had been regulated, as well as the steps taken by regulatory authorities to address the specific risks arising out of the bank's financial ill-health, had contributed to the state of affairs that culminated in the U.K.'s first bank run since the Victorian era.[100] In a similar vein, the FSA's own report[101] into its handling of the Northern Rock crisis identified a number of serious failures in oversight that, while treated as exceptional by the FSA, appear to have been symptomatic of an underlying malaise within the regulatory system as a whole. A short summary of these lapses is described here.

First, the FSA may have failed to supervise Northern Rock with sufficient depth and rigor. To illustrate, the failure to recognize the risk inherent within Northern Rock's business model and to challenge the assumptions that were underlying its commercial practices permitted the bank to continue its risky conduct unchecked, without regard to the potential for crisis (at least for Northern Rock, if not for the system as a whole) that this posed. Despite its commitment to risk-based oversight, the FSA did not conduct sufficiently frequent ARROW assessments[102] for a firm that had been identified as "high impact," and that thus required closer and

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[97] *Northern Rock: Lessons of the Fall*, ECONOMIST, Oct. 18, 2007.

[98] HOUSE OF COMMONS TREASURY COMMITTEE, FIFTH REPORT OF SESSION 2007-08: THE RUN ON THE ROCK 13 (Jan. 24, 2008); ECONOMIST, *supra* note 97.

[99] *Id.*

[100] *Id.* at 3-4.

[101] FINANCIAL SERVICES AUTHORITY, *supra* note 96.

[102] ARROW stands for the *Advanced, Risk-Responsive Operating FrameWork* and is used by the FSA to assess the risks attaching to a firm's conduct in relation to its own internal organization as well as its place in the market. As a principles-based regulator, the ARROW assessment method is used, at least in theory, to permit the FSA to tailor the rigor of its supervision to a firm's risk profile. FSA, THE FSA'S RISK-ASSESSMENT FRAMEWORK (Aug. 2006).

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more exacting supervision.[103] Indeed, the Treasury Select Committee's report stated that Northern Rock's very rapid expansion on the crest of the investment boom in mortgage-backed securities was a sure sign that it was vulnerable to over-heating and, worryingly, that this should have been spotted by a regulator that had not been "asleep on the job."[104] In addition, Northern Rock had suffered an abnormally sharp dip in its share price, relative to other banks, and issued a profits warning in June 2007—a sign that appears to have been largely ignored by the FSA's Northern Rock supervisory team.[105] In expert testimony given to the Treasury Select Committee, it was noted that Northern Rock's particularly steep dip in share price—attributed to its special vulnerability to the mismatch between bank base rates and the upwardly fluctuating interest rates in the inter-bank lending market—should have put the FSA on notice that the bank was experiencing difficulties in obtaining liquidity.[106] Accordingly, a poor grasp of market fundamentals (at least, sufficient to understand the implications of the short-term financial techniques being used by firms under its supervision), incomplete data collection during stress testing with Northern Rock, and lengthy gaps between ARROW risk assessments contributed to skew Northern Rock's regulatory profile, with the result that bad practices were simply permitted to continue.

Second, as an organization, the FSA's handling of Northern Rock demonstrated deficiencies in its allocation of resources and its deployment of expertise in exercising oversight. Most damning, the FSA failed to allocate conduct of the file to the appropriate unit internally, passing it to the insurance rather than to the banking division. Compounding this ostensible lack of expertise, the FSA was understaffed, and with high staff turnover (it was noted that three department heads oversaw Northern Rock over a short period of time),[107] it was unable to preserve the continuity of a dedicated team for the bank, potentially contributing to its failure to recognize the emerging risk posed by the Northern Rock business model.[108] On the level of its own internal information collection on Northern Rock's activities, the FSA once again came up short. Record keeping of meetings between the FSA's Risk Assessment Panel and Northern Rock's supervisors was inconsistent, and often meeting notes were not kept. Further, supervisors did not provide the Panel with

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[103] *Id.* at 32.

[104] HOUSE OF COMMONS, *supra* note 98, at 22.

[105] *Id.* at 23.

[106] *Id.*

[107] Christine Seib, *The FSA Northern Rock Report: The Regulator that Missed the Collapse*, TIMES, Mar. 27, 2008.

[108] HOUSE OF COMMONS, *supra* note 98, at 22.

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developed financial assessments on Northern Rock and did not enter details of the firm's risk profile into the FSA's database, so that no real paper trail documenting the worsening state of the bank appeared. As above, FSA did not consistently keep meeting records detailing discussions between the bank's management and FSA, retaining only one partial record from eight so-called "close and continuous"[109] meetings between the FSA and Northern Rock.[110]

Finally, based on advice given to Northern Rock, it would appear that the FSA did not fully tailor its advice to the risks and organizational shortcomings of the bank. The Northern Rock senior management, for example, was given permission to carry out regulated activities as "approved persons" under the FSA's authorization regime, despite failing to show appropriate professional qualifications for the positions. As noted by the Treasury Select Committee, neither the Chairman nor the CEO of Northern Rock had obtained the requisite professional qualifications to perform the senior management and approved persons' functions at Northern Rock.[111] More critically, the FSA granted Northern Rock a waiver to allow it to use the advanced method for calculating its regulatory capital reserves under Basel II.[112] The waiver allowed Northern Rock to declare a healthy interim dividend on the basis that the waiver and its own internally calculated asset realizations could be measured to give it a regulatory capital surplus for the following three or four years.[113]

As stated earlier, the U.K.'s supervisory framework allows for coordination within the tripartite committee of the Bank of England, the Treasury, and the FSA to provide for the appropriate allocation of regulatory resources, in particular with a view to managing systemic risks and crises. However, the operation

[109] Close and continuous meetings are arranged between the FSA and "high impact" firms to ensure regular contact over the regulatory period between full ARROW assessments. FSA, *supra* note 102.

[110] Seib, *supra* note 107.

[111] HOUSE OF COMMONS, *supra* note 98, at 33.

[112] Under Basel II provisions for calculating credit risk, firms are allowed to choose (i) a foundation calculation method, or (ii) use of "advanced methods" for reporting. Under the foundation approach, firms can provide supervisors with their estimates of their probability of default, leaving supervisors to apply further calculations in relation to other risk elements. In the advanced approach, firms are given more autonomy to provide their own estimates and therefore provide estimates of probability of default, loss given default, exposure at default and effective maturity. Supervisors must grant waivers to any firm looking to use an advanced method for calculating credit risk under Basel II rules. Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version* 59 ¶ 245 (June 2006).

[113] *See* HOUSE OF COMMONS, *supra* note 98, at 25.

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of this committee in the management of the Northern Rock case, specifically when it became clear that Northern Rock was heading for a serious liquidity crisis, was faltering. As with the conduct of the FSA, the show of regulatory force by the tripartite committee was unsteady in a manner that may have created uncertainty for Northern Rock, but more importantly, for the markets and for Northern Rock's depositors.

A key criticism leveled in this regard relates to the lack of readiness displayed by the tripartite committee in acknowledging and reacting to the extent and depth of Northern Rock's troubles.[114] After rejecting two private bids for the bank as too low, the Bank of England cited, *inter alia*, the slippery slope of moral hazard to justify its unwillingness to provide funding to Northern Rock, despite pressure from the FSA to act, extending the course of the crisis by some number of days. When the funding was finally provided, miscommunication by the committee and a perceived lack of conviction by official support,[115] together with the then-limited statutory deposit protection,[116] was seen as the cause for the long stretches of depositors lining up to demand a return of their money, setting the stage for a "run" on the bank with the potential to spill out more widely into the financial system.[117] Manifesting a lack of leadership, where neither the FSA nor the Bank of England appeared to take charge of the situation, the apparent dissonance between the Bank of England and the FSA during the crisis underscored a difference in the regulatory priorities of the two institutions, rather than demonstrating the coordination that had been promised and practiced in trial runs conducted by the committee for just such a crisis.[118]

Subsequent to Northern Rock, the tripartite committee was required to engineer the rescue of Bradford and Bingley, another regional bank with a niche hold in the mortgage market, by taking the bank's mortgage book into state hands and selling off the deposit-taking arm to Santander, a Spanish bank. In the wake of lessons learned from Northern Rock, the committee acted swiftly to rescue the bank, fearing once again a potential systemic spread into the banking sector, but this time legislatively equipped[119] to act in accordance with specified timetable and

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[114] *Id.* at 3.

[115] *Id.* at 111.

[116] *Why a Run on the Rock but Not Countrywide?*, WALL ST. J., Oct. 18, 2007, http://blogs.wsj.com/economics/2007/10/18/why-a-run-on-northern-rock-but-not-countrywide/.

[117] *See* HOUSE OF COMMONS, *supra* note 98, at 111.

[118] *Id.*

[119] Banking (Special Provisions) Act 2008 (BSPA). On February 12, 2009, the U.K. enacted into law the Banking Act 2009, to coincide with the expiry of BSPA. The BSPA was

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procedures.[120] In many ways, as a specialized northern England bank and an expert in the mortgage market (especially in the buy-to-let sector),[121] Bradford and Bingley's operating profile appears, at least superficially, to be similar to that of Northern Rock. While it seems likely that Northern Rock's demise had negative repercussions for investor confidence in Bradford and Bingley (as amply demonstrated in June 2008 by Bradford and Bingley's failure to generate sufficient market interest to carry out a rights issue),[122] it remains to be seen whether Bradford and Bingley could also have been allowed to slip under the regulatory radar by the FSA in the months and years before the financial crisis fully ripened. In the absence of thorough inquiries into the failure of Bradford and Bingley, such as those conducted by the Treasury Select Committee or by the FSA for Northern Rock, any analysis of the mistakes made in understanding its internal business models, supervising its flow of liquidity, ensuring proper risk review, and conducting stress tests remains highly speculative. Nevertheless, the fact that Northern Rock, Bradford and Bingley, and Halifax Bank of Scotland (HBOS)—U.K. banks that were each very heavily reliant on the mortgage market[123]—have all ended up sold or nationalized provides some evidence that particular risks were permitted to fester within the system, despite risk-based oversight, making banks that had exposed themselves to concentrations of these risks almost certain to be among the first in line to fail.

The critical question in respect of the above, discussed later in Part V, is whether the consolidated model of oversight created structural supervisory vulnerabilities that were exposed during the financial crisis. While a big picture

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passed to give a legislative basis for the nationalization of Northern Rock and the procedures taken by the tripartite authorities in that regard. The Banking Act is intended to formalize and refine those arrangements (among other things). The showpiece of the legislation is the establishment of the Special Resolution Regime (SSR) that gives the tripartite authorities a range of methods to deploy for the rescue of failing institutions. The Act provides for mechanisms to rescue failing banks, by giving authorities greater freedom to control the flow of information to the public in the interests of avoiding investor and creditor runs. The Act also gives the power to make regulations for failing investment banks.

[120] Edmund Conway and Katherine Griffiths, *Bradford and Bingley Rescue Will Cost the Taxpayer Billions*, THE TELEGRAPH, Sept. 29, 2008, *available at* http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3094014/Bradford-and-Bingley-rescue-will-cost-taxpayer-billions.html.

[121] *Id.*

[122] Patrick Hosking and Christine Seib, *FSA Puts Pressure on Top Five Banks to Support Bradford & Bingley Rights Issue*, THE TIMES OF LONDON, June 10, 2008, *available at* http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article4100459.ece.

[123] BBC News, *Treasury to Nationalise B&B Bank*, Sept. 28, 2008, http://news.bbc.co.uk/2/hi/business/7640143.stm.

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assessment suggests that Northern Rock and related crises were symptoms of a wider global problem and that, in this regard, regulators could perhaps be excused for failing to spot the brew of trouble in the North Atlantic and European markets, the issue in the context of reform is whether the consolidated supervisory model should have made a difference in regulatory quality and, if problems arose despite its advantages, whether its structure gave rise to certain deficiencies that should be accounted for in plans for reform. In this respect, it may be helpful to keep in mind the broader rationales for regulation set out earlier in this paper and the extent to which these can be more or less effectively institutionalized within a consolidated regulatory framework.

B. Lehman Brothers and AIG

The conduct of the U.S. regulatory authorities in the run up to and following the collapse of Lehman Brothers and the subsequent rescue of AIG has been the subject of considerable scrutiny and analysis.[124] Commentators have suggested that the quality of supervision, and in particular the supervision of investment banks, has been exposed as sorely deficient and structurally limited in vision following the escalation in the financial crisis.[125]

Notwithstanding the thicket[126] of rules regulating financial services in the U.S., the regulatory framework has traditionally been regarded as robust, combining investor protection with a perception of high-quality regulation for firms. The U.S. capital markets have been seen to attract foreign investment through an expectation of stability, certainty through rules, transparency, regulator access, and an active enforcement of rules through the court system.[127] The independent nature of most regulatory agencies (with the exception of certain bureaus within the Treasury, namely the OCC and the OTS) allows a bi-partisan approach. Also, given the specialized nature of each body, supervision can be highly expert, focused and responsive to the local market, where it is undertaken at the state level. Nevertheless, as set out below, the multiplicity of agencies, together with a near-exclusive reliance on a less-than-malleable body of rules, left supervisors slow to move in addressing the concentrations of risk percolating through the financial system as a whole.

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[124] *See, e.g.*, Aline van Duyn, Deborah Brewster & Gillian Tett, *The Lehman Legacy: Catalyst for the Crisis*, FIN. TIMES, Oct. 12, 2008, *available at* http://www.ft.com/cms/s/0/ea92428c-9887-11dd-ace3-000077b07658.html; *see also* SCOTT, *supra* note 17.

[125] Skeel, *supra* note 2, at 734.

[126] SCHUMER-BLOOMBERG REPORT, *supra* note 29, at 89.

[127] Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 77, 104 (2008).

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First, despite the specialized regulation offered by a spread of focused functional regulators, fragmentation and regulatory gaps created structural impediments to understanding locations of risk within the system and to identifying institutions such as Lehman and AIG that were gradually developing vulnerabilities to such risk. As is well known, the roots of the crisis lie in the U.S. mortgage market—both the primary market where mortgages are brokered and originated—and the secondary market, where mortgage-backed securities ("MBS") are structured and traded, extending to such financial engineering as collateralized debt obligations ("CDOs") and derivative instruments such as credit default swaps ("CDS"), concluded to hedge the risks arising from trades in such products. As set out above, the development of sophisticated financial instruments, taking advantage of the availability of cheap credit, the housing bubble and the large (and quick) returns from highly leveraged investments, have not respected traditional regulatory categories, falling neatly into the jurisdictional purview of one or other functional regulator. Indeed, as detailed below, the risk accumulations that culminated in the Lehman and AIG failures arguably fell into the gaps left between the scope of control exerted by the various regulatory bodies involved.

In the case of the primary market, the regulation of banks offering mortgages is handled variously by the OTC, OCC, the Fed and the FDIC, in addition to state bank regulators. However, industry commentators have argued that the highly prescriptive, rules-based oversight used by these bodies restricted their ability to keep pace with product innovation.[128] In particular, banks have increasingly relied on securitizing debt on their books—mortgages that they have originated, or otherwise purchased from mortgage brokers—and transferring this debt to a special purpose vehicle ("SPV") that then packages it into complex, structured products like CDOs for sale to investors. However, while securitization may have outwardly removed risk from banks' balance sheets, it can also be seen as merely dislocating the risk, arguably increasing its seriousness by creating new risks with possible systemic impact, such as the credit risk not just on the mortgagees, but also on the SPV, the risk that insurance through CDS will not be honored, valuation risk on the securities, or counterparty risk on ongoing trades with the securities.

Further, behind the scenes, it has been estimated that mortgage brokers have been playing an increasingly prominent role in mortgage selling, increasing the riskiness of the loans institutions were holding. The numbers suggest that large majority of sub-prime loans were originated by mortgage brokers. For 2006, it has

128 THE FINANCIAL SERVICES ROUNDTABLE, *supra* note 4, at 38.

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been estimated that brokers were involved in 63.3% of sub-prime mortgage originations, with 19.4% deriving from the retail sector and the rest through correspondent lenders – the overall share of broker-originated mortgages increasing from 2003-2006.[129] As brokers generally have a very short-term interest in the mortgages they sell, rather than the longer-term commitment of actual lenders, they have been particularly vulnerable to giving in to a lax approach in vetting the financial health of borrowers, creating, as Eichengreen has argued, a moral hazard at the first step of the process.[130] [131]Mortgage brokers are not regulated at the federal level, although they may operate under licenses in some states. Accordingly, along with the mortgage brokers, the ability of banks to circumvent risk through securitization may be seen to have created a structural disincentive for a prudent, selective approach to investigating the real creditworthiness of borrowers. Indeed, the statistics over recent years show that lenders offered mortgages to more and more risky borrowers in the period between 2001 and 2006,[132] with the percentage of subprime originations going from 5% of all originations in 1994, to 20% in 2006.[133]

With respect to the primary market in mortgage lending, no one agency is charged with supervision over the players involved. Compounding the supervisory gaps, there is no formal mechanism for state and federal agencies to coordinate understanding and management of the risks at the structural and system-wide level. Only the Fed has a seat at the PWG table.[134]

In the secondary market, the market in which AIG and Lehman were operating, regulation is similarly divided across agencies and includes government-backed agencies Fannie-Mae and Freddie-Mac. The major investment banks, such as they were before October 2008, fell under the supervision of the Securities and Exchange Commission (SEC), which, while independent, did not have the authority to provide liquidity assistance to distressed firms under its supervision and could not have acted against mortgage originators engaging in reckless lending practices in the

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129 MAJ. STAFF OF THE J. ECON. COMM., 110TH CONG., THE SUBPRIME LENDING CRISIS 17 (2007).

130 BARRY EICHENGREEN, 13 QUESTIONS ABOUT THE SUBPRIME CRISIS (2008), *available at* http://www.econ.berkeley.edu/~eichengr/13%20questions.pdf.

131 Associated Press, *Brokers, Bankers Play Subprime Blame Game: Claims that Commission-Driven Salespeople, Lenders to Blame for Mess*, MSNBC, May 22, 2007, http://www.msnbc.msn.com/id/18804054/.

132 Sue Kirchoff & Judy Keen, *Minorities Hit Hard by Rising Cost of Sub-prime Loans*, USA TODAY, Apr. 25, 2007, at 1B.

133 Ben Bernanke, Fostering Sustainable Homeownership, Speech to the National Community Reinvestment Coalition Annual Meeting (Mar. 14, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20080314a.htm.

134 THE FINANCIAL SERVICES ROUNDTABLE, *supra* note 4, at 38.

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primary market. Moreover, the secondary market also included banks that invested in as well as originated, inter alia, MBS and that were regulated by the Fed and other banking regulators. Complicating the picture, investment banks and banks dealing in products such as MBS were involved in a number of capacities, for example, trading for their clients as broker-dealers, trading on their own accounts, acting as lenders to SPVs through investment in commercial paper, issuing commercial paper to meet their own funding obligations, or providing clearing and settlement services for securities trades (e.g. Citi, Bear Stearns). Further, as in the primary market, investment in toxic securities was not always undertaken by the investment bank or other financial institution directly, but through SPVs, or hedge funds, devices that would have limited the full exposure of the risk on balance sheets and been less visible to regulators.[135] Finally, with respect to AIG, insurance firms were not regulated at all at the federal level, with oversight left to the 50 state insurance commissions. The CDS peddled by AIG to the market behaved at once like insurance, securities or futures products, that—blurring the lines between the supervisory purview of the SEC, CFTC and state insurance commissions—were left largely unregulated.[136] As such, there was little heed paid to the prudential impact of AIG's business and how much capital it should have held given the risks that it was taking on as a result of its offerings to the market. Accordingly, these devices proliferated to mitigate (on paper) the assumption of risk on subprime mortgage securities by financial institutions, such that they were able to skew the allocation of risk by and between institutions as well as building a type of technical impunity into the assumption of risk that made firms susceptible to the temptations of investment in problematic but high-yielding securities. It has been estimated that AIG had written CDS with a notional exposure of $441 billion, with $58 billion written on subprime mortgage backed securities.[137] Indeed, the full extent of AIG's obligations and role in the market still continues to emerge - as evidenced by revisions in the terms of the AIG bailout and the controversies that have ensued since regarding the depth of the crisis at the insurer.[138]

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[135] Skeel, *supra* note 2, at 734.

[136] Posting of Elizabeth Brown to The Conglomerate Blog, http://www.theconglomerate.org/2008/10/turning-a-blind.html (Oct. 21, 2008).

[137] *Size Matters; AIG's Rescue*, ECONOMIST, Sept. 20, 2008.

[138] Mary Williams Walsh, *Drawing Fire, Geithner Backs Rescue of AIG*, N.Y. TIMES, Jan. 28, 2010, at A3, *available at* http://www.nytimes.com/2010/01/28/business/28aig.html?scp=2&sq=AIG&st=cse; Doug Diamond & Anil Kashyap, *Diamond and Kashyap on the Recent Financial Crisis*, N.Y. TIMES, Sept. 18 2009, *available at* http://freakonomics.blogs.nytimes.com/2008/09/18/diamond-and-

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Accordingly, the regulatory picture emerging for both the primary and the secondary market reinforces the broken lines within the supervisory landscape. While functional supervisors should have had the tools to regulate risk on the books of those operating in the particular sector they supervised, this oversight and control did not extend to other market players outside of their purview that were engaged in building similar risks on their books. Banks and investment banks, for example, both trading in the secondary market, were supervised by different functional regulators and were subject to varying capital adequacy requirements despite investing in and selling similar products. Additionally, the predatory lending practices at the start of the chain were left outside of any one supervisor's purview. As a result, although not making it impossible, the fragmented structure rendered a full-picture understanding of risk emerging from the widespread investments in toxic securities and the ultimately inadequate measures that were being taken to mitigate such risks difficult to obtain.

Second, as stated above, the separate regime to which investment banks have traditionally been subject—regulated principally by the SEC, rather than by the Fed and through a different legislative scheme on insolvency, as set out below—may have helped create a diverging framework for managing involvement in infrastructure by certain firms. In particular, the system may have given single institutions the ability to develop expertise in the provision of infrastructure services that were very important to the operation of the financial markets, for example, clearing and settlement for securities. Allowing systemic involvement in infrastructure, creating industry dependence on such functions that cannot always be easily taken on by others in the market when a provider fails, may tie the hands of regulators when it comes to making decisions as to whether or not an institution should be rescued, potentially continuing the existence of businesses that should be unwound or restructured through proper insolvency proceedings.

This issue also came to the fore in the case of AIG. Deeply entangled in the system through its involvement in the provision of CDS, AIG was absorbing risks generated in the market on unsound investments products, and its prospective failure was considered to have posed a special structural risk to the market with the potential to create systemic chaos.[139] Accordingly, as Bernanke has argued, it had to

kashyap-on-the-recent-financial-upheavals/; *see also* Press Release, Federal Reserve System (Nov. 10, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/20081110a.htm.

[139] Ben Bernanke, Chairman, Federal Reserve, Stabilizing the Financial Markets and the Economy, Address to the Economic Club of New York (Oct. 15, 2008) (transcript available at http://www.federalreserve.gov/newsevents/speech/bernanke20081015a.htm); Walsh,

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be saved and bankruptcy was simply not an option.[140] Its rescue has since proved expensive,[141] indicating the heightened level of Fed/Treasury concern at the implications of potential AIG insolvency as well as an absence of a clear understanding of these unraveling liabilities in the course of its bailout.

In contrast, on the assumption that the failure of depository institutions is systemically costly, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICA)[142] provides a relatively orderly regime for unwinding their obligations. Once certain capital-based thresholds are crossed, the Act kicks in to enable corrective action to be taken—thus working to prevent knee-jerk regulatory responses in respect of rescues—and importantly, to start the process of closing the bank at a time when it remains in the black. A key contribution of the Act is to enable the establishment of a type of "bridge bank" by the FDIC (once the bank is in receivership) that can pay off depositors and creditors and sell such assets as it can to realize value for the institution.[143]

Such a regime would have been particularly beneficial for the investment banks and others significantly entangled within the system, permitting their resolution without causing the spiking fevers then seen within the financial system. Structurally significant institutions like AIG, with their complex risk and legal profile, would also have benefited from such an ordered arrangement. While no longer relevant for investment banks, now with the major players like Goldman Sachs and Morgan Stanley converted into depository institutions, the argument—that the cost to and entanglement in the economy of an institution should be assessed without reference to the sectoral, regulatory category it is considered as falling into[144]—remains valid. Given the intricate engagements of non-depository institutions in the financial markets (e.g. hedge funds or insurers like AIG), introducing a more general FDICA-type regime may be helpful.[145] Related to this point, as with the operation of the U.S. payments infrastructure, there is therefore a

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supra note 138.

[140] *Id.*

[141] Andrew Ross Sorkin & Mary Williams Walsh, *U.S. Is Said to Offer Another $30 Billion in Funds to A.I.G.*, N.Y. TIMES, Mar. 1, 2009, *available at* http://www.nytimes.com/2009/03/02/business/02aigweb.html.

[142] Pub. L. No. 102-242, 105 Stat. 2236.

[143] Morris Goldstein, The Subprime and Credit Crisis, Speech to the Global Economic Prospects Meeting at the Peterson Institute for International Economics (Apr. 3, 2008).

[144] Willem Buiter, *Self Regulation Means No Regulation*, FIN. TIMES BLOG, Apr. 10, 2008, *available at* http://blogs.ft.com/maverecon.

[145] See later discussion of the Obama administration's proposal for financial services reform.

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case to be made for infrastructure (such as a central counterparty to trades) in derivatives clearing and settlement to be provided by an independent institution, separate from those that use it, or otherwise by an institution representing the combined effort of key users and supervised by a single regulator able to monitor accumulations of risk and restrictions of liquidity.

Third, it is arguable that the extent to which certain institutions are judged to be entangled within the system biases the decision-making of regulatory bodies. However, such decisions are not always easy to make in the heat of crisis, as seen in the case in the varying approaches taken to the rescues of Lehman and AIG. The decision taken by the Fed and the Treasury in relation to Lehman in particular has been loudly criticized.[146] Notwithstanding the advantage of hindsight, the decision to allow Lehman to fail set in motion a violent series of shocks that have been blamed for an intensification of the financial crisis.[147] Most critically, the system was rapidly drained of liquidity. The Lehman collapse reduced or indeed completely obliterated the value of some securities, for example, large holdings of Lehman commercial paper, held by money market funds,[148] creating a panicked rush to redeem securities held in these funds and ensuring that MMFs were drained of liquidity virtually overnight.[149] In addition, the commercial paper market was affected by the loss of one of the biggest dealers in commercial paper, such that it could only be revived through the novel step of making the Fed an investor in commercial paper issued by non-depository as well as depository institutions under the Fed's commercial paper program.[150] Finally, even though the Fed later argued that the market should have been prepared for Lehman's failure, given the well-publicized nature of the losses it had suffered over the course of the subprime mortgage crisis, the reaction of the market indicated that the death-knell nevertheless came as a shock. With no institution seemingly too big to fail, the risk-appetite for lending in the inter-bank market diminished, with the result that borrowing between financial institutions became prohibitively expensive.[151]

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[146] *See* Van Duyn, Brewster and Tett, *supra* note 124.

[147] *Id.*

[148] INVESTMENT COMPANY INSTITUTE, REPORT OF THE MONEY MARKET WORKING GROUP 53-57 (Mar. 17, 2009).

[149] The $62 billion money market fund, Primary Reserve Fund, "broke the buck" after its $785 million portfolio of Lehman commercial paper was valued at zero after the Lehman collapse. *Reserve Primary Fund: Investors May Lose*, USANEWS, Sept. 17, 2008, *available at* http://www.usnews.com/blogs/new-money/2008/9/17/reserve-primary-fund-investors-may-lose.html.

[150] Press Release, Federal Reserve Board of Governors System (Oct. 7, 2008), *available at* http://www.federalreserve.gov/newsevents/press/all/2008all.htm.

[151] *See* Van Duyn, Brewster & Tett, *supra* note 124.

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The systemically serious nature of Lehman's operations was thus very clearly exposed following the decision to allow it to fall on its sword. When set against the rescue of AIG, the crisis brought into relief the hair-line judgment involved in determinations of which institutions or risks may be said to constitute a systemically relevant threat and which do not, or do so to a more limited extent.

As a result, questions remain as to how systemic risk has been assessed by regulators and whether such assessments tally with the events that have followed. The decision to allow one of the major players in the market to fail, triggering enforcement of the CDS hedging against default, virtually necessitated the rescue of AIG, the insurer that had written the CDS protections for investors in mortgage securities. Although the Treasury and the Fed have maintained that taxpayer funds would never have been placed at Lehman's disposal,[152] given the extremely poor quality of its collateral,[153] this position appears disingenuous. For one, despite maintaining that it was not legally permitted to lend on the back of the low-grade collateral, the day after the Lehman collapse, the Fed opened its Primary Dealer Credit Facility to banks and investment banks that were able to post a much poorer quality of collateral than previously, including junk bonds, equities, whole mortgages, and sub-prime mortgage backed securities.[154] Further, section 13(3) of the Federal Reserve Act provides near un-reviewable discretion for the Fed to provide funds "secured to its satisfaction".[155] It is therefore arguable that, had the Fed taken a decision to provide a rescue package to Lehman, the poor quality of collateral, while important, would have been unlikely to be decisive. Rather, the determination appears to have been based on considerations of systemic risk made in the heat of crisis, with the application of notionally subjective assessments of the importance of a firm's entanglements within the financial system. In addition, U.S. authorities, pushing the broader policy goal of curbing moral hazard in the market, appeared to apply this somewhat selectively, notably against Lehman, but not others like AIG or Bear Stearns, generating uncertainty that added fuel to the fires of possible systemic contagion.

With hindsight, taking into account the severe constrictions in the market that followed Lehman's demise, an assessment of systemic risk was not feasible. For one, the decision was primarily one taken by the Treasury and the Fed, neither of

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[152] *Id.*

[153] Bernanke, *supra* note 139.

[154] Edmund Andrews, *Fed Loosens Standards on Emergency Loans,* N.Y. TIMES, Sept. 15, 2008, at A19.

[155] Federal Reserve Act § 13(3), 38 Stat. 251 (1913).

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which had any formalized, active supervisory duties over Lehman before the financial crisis, contributing to a deficiency in the longitudinal information available to them. In addition, the judgments made appear to have valued certain types of entanglements above others, for example, whether a failing institution provided infrastructure services (e.g. Bear Stearns), or whether it was substantially involved in risk management across the market (e.g. AIG), while underplaying, or otherwise discounting others, such as the firm's role in the commercial paper market, as a prime broker, or the potential impact of the firm's demise on the system-wide psychology of the market.

Going forward, regulators could consider formalizing (at least to some degree) the factors underlying a determination of systemic entanglement. Without some transparency on this matter, decisions that eventually result in severe if not systemic market distress may be viewed as having been made on an *ad hoc* basis.[156] In any event, although reform proposals are being formulated to specifically address systemically significant institutions, this provides little comfort in tackling and understanding systemic risk at a deeper level. As discussed further below, such risks, while especially salient in the context of large, entangled institutions, can exist quite independently of them, for example, in the case of Northern Rock, a relatively small bank that was able to generate considerable and sudden financial distress for a marketplace unprepared for the possibility of its demise.

The crisis has of course not stopped with Lehman or AIG. Critically infecting such embedded and once-vaunted institutions as Citibank and Bank of America, the depth of the risk seems to have taken regulators by surprise.[157] As in the case of the U.K, the extent of the difficulties provides a useful opportunity for institutional introspection. It is certainly easier to critique the U.S. regulatory framework, given the patchwork of sectoral regulation at both the state and federal level that nevertheless leaves important tracts of the financial markets without adequate coverage. While the individual agencies may have relatively long histories and the experience that should derive as a result, there is a sense that the architecture as a whole is unable to match that created by modern financial institutions, notably after the enactment of the Gramm-Leach-Bliley Act, and the increasingly complex,

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[156] *See* U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 23 (2009) (The factors that make an organization systemically important could create moral hazard, by letting institutions know that they are too big to fail. Further, it may create incentives for smaller institutions to work towards growth in the interests of becoming systemically important.); *see also* COMM. ON CAPITAL MARKETS REGULATION, *infra* note 171.

[157] Thomas Friedman, *Obama's Ball and Chain*, N.Y. TIMES, Mar. 3, 2009, *available at* http://www.nytimes.com/2009/03/04/opinion/04friedman.html?em.

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category-oblivious investment activities that they are engaged in. Further, regulator reliance on the industry's self-regulation to fill in gaps in policing now also appears to be a largely discredited strategy, regarded as ideologically defunct by commentators[158] and regulators[159] alike. However, while the system may be showing its cracks, the question arises whether the scale of the present crisis may be sufficient to spur a radical reform agenda to create a system that is better equipped to manage future market distress. While crises in the U.K. (e.g. the collapse of Barings bank, the Robert Maxwell pension scam, and the near-failure of Equitable Life) created popular and political charge for full-scale reform, similar, or indeed worse, experiences in the U.S. have led to a plastering over the cuts with legislation but within the structure of the traditional framework.[160] The savings and loan crisis in the 1990s may well have been rattling but the major structural reform in that decade came in the form of the Gramm-Leach-Bliley Act, passed without any underlying integrating change in the regulatory framework to oversee the greater consolidation in financial services provision. Similarly, the Enron and Worldcom scandals resulted in SOX and the formation of a new agency in the form of the Public Company Accounting Oversight Board, rather than calls for more rounded, risk-based oversight. Finally, popular and political discontent over the New York Stock Exchange compensation crisis or indeed the collapse of the technology bubble has not given way to any serious proposals for structural reform in those areas.[161] The causes for this legislative inertia have been set out above.[162] However, commentators seem agreed on the strong political headwind

[158] Willem H. Buiter, *Lessons from the Global Credit Crisis for Social Democrats* (Background paper for the Dr. J.M. Den Uyllezing Lecture 2008 in de Rode Hoed, Amsterdam, Dec. 15, 2008).

[159] *The Financial Crisis and the Role of Regulators: Hearing Before the H. Comm. on Oversight and Reform*, 111th Cong. (Oct. 23, 2008) (testimony of Alan Greenspan) ("Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief."); *see also* Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES, Oct. 23, 2008, *available at* http://www.nytimes.com/2008/10/24/business/economy/24panel.html?_r=1&hp&oref=slogin.

[160] Indeed, the current crisis has led to calls for the operations of the FSA to be reformed, *inter alia*, to improve the FSA's enforcement policy and bring to an end the "light touch" approach that has been seen as insufficient to protect the markets. In this regard, Lord Turner, Chairman of the FSA, published his review of the regulation of banking, spelling out in that report the desirability of reforming the FSA's erstwhile approach to regulation. *See* LORD TURNER, THE TURNER REVIEW: REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS (Mar. 2009); *see also* SIR JAMES SASSOON, THE TRIPARTITE REVIEW: A REVIEW OF THE UK'S TRIPARTITE SYSTEM OF FINANCIAL REGULATION IN RELATION TO FINANCIAL STABILITY (Mar. 2009).

[161] Jackson, *supra* note 3, at 14.

[162] *See id.* at 6-8.

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likely to be encountered in any move to dilute the power of not just the federal agencies at one level, but also of the state regulators that have regulatory monopolies in certain key areas such as insurance/mortgage brokerage. Logistical anxiety relating to the difficulties in hiring, firing and conjoining personnel, fusing an integrated regulatory identity, and determining what do in the interim with an unrelentingly litigious audience, renders any viable way forward for reform bleak. Nevertheless, as set out in the next section, the scale of the present crisis is sufficiently unprecedented in the post-Depression era to see a serious re-thinking of the current framework. More importantly, the coordinated actions of the Treasury and the Fed in executing the bailout may have whet the appetite and set the stage for considering the creation of a more integrated regulatory plan.

IV. Crisis and Consolidation

As set out above, for some time academics and practitioners have raised concerns about the suitability of the U.S. regulatory framework to an ever more functionally converged financial marketplace. Proposals for reform have therefore focused on the introduction of greater consolidation into the U.S. regulatory structure, at least at the federal level.[163] While the designs of the proposals put forward have varied in the depth of consolidation, the common thread of argument would appear to be strongly inclined towards a more unifying regulatory model.[164]

This part analyzes the major trends in thinking on this issue, providing a brief overview of some of the key proposals that have been developed to address reform in the regulatory system. The financial crisis has added a novel dynamic to the debate. As this paper demonstrates, the actions of regulators and policymakers in the course of the turmoil have already changed the landscape, such that any future design for reform ought to address the implications of these developments. However, the broader analysis in this section seeks to address the big questions that have been raised in the context of the crisis, discussions of which can helpfully make clearer the outline for a new framework. First, under whose authority and under what regulatory conditions should systemically significant financial institutions be rescued in cases of financial emergency? Proposals for reform need to be clear on how systemic risks should be regulated and who should be tasked with the role of bailing out failing institutions. Secondly, what oversight role can and

[163] *E.g.*, U.S. DEP'T OF THE TREASURY, *supra* note 51; U.S. DEP'T OF THE TREASURY, *supra* note 156; Brown, *supra* note 30; Jackson, *supra* note 92.

[164] Brown, *supra* note 30.

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should be played by states? The new structure must properly digest and determine the role of the states in the regulation and supervision of financial services. Thirdly, how should regulatory responsibilities be allocated between regulators? The new framework should provide greater clarity in the division of regulatory responsibilities between overseers. Fourthly, on a related note, what should be the division of supervisory resources across the system? Finally, how can regulatory rationales be better incorporated into the design of the new framework? Underpinning the discussion, a prospective outline should seek to optimally reflect the key regulatory rationales identified in this paper as an overarching and centrifugal force in its future structure.

A. Proposals for Reform

Reform of the financial regulatory system can take a number of shapes that each institutionalize varying degrees of consolidation and normative allocations of regulatory and supervisory responsibility between overseeing authorities. Whilst recent proposals put forward in the House (Wall Street Reform and Consumer Protection Act (H.R. 4173)) as well as by the Senate Committee on Banking, Housing and Urban Affairs (Restoring American Financial Stability Act 2010) have gained national visibility,[165] the scope of financial regulatory reform is wide-ranging in the depth and breadth of structural reform that may be undertaken.[166] This section seeks to summarize the proposals crystallizing the key strands of thinking in this area.

- Proposal 1—amalgamate the current plethora of state and federal regulatory into a single regulator.[167] This would be the most radical solution.

- Proposal 2—amalgamate federal regulators into a "twin peaks" model whereby one is responsible for managing financial stability, while the other agency fulfills conduct of business oversight.[168]

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[165] *E.g.*, Brady Dennis & David Cho, *Obama Administration Vows to Defend Financial Reform Provisions in Bill*, WASH. POST, Apr. 8, 2010, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/04/07/AR2010040705021.html?hpid=sec-business.

[166] *E.g.*, GOV'T ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM, GAO 09-216 (Jan. 2009).

[167] U.S DEP'T OF THE TREASURY, *supra* note 51; Brown, *supra* note 30, at 1.

[168] GROUP OF 30, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE, 30-31 (Oct. 6, 2008).

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- Proposal 2A—A variant of this model—the "three peaks" model was proposed in the Treasury's 2008 *Blueprint*, which envisaged the eventual creation of a market stability regulator, a prudential supervisor and a supervisor of market conduct.[169] In the *Blueprint*, the Fed is given a more robust role in ensuring market stability with the remit to monitor risks across the financial market.[170] In addition, the Treasury recommends the creation of "two foothills" with smaller agencies dedicated to overseeing corporate securities issuers and the other to contain government guarantee funds.

- Proposal 2B—A further take on the "twin" and "three peaks" model, as recently put forward by the Committee on Capital Markets Regulation, suggests that the current framework should be reformed to comprise a twin or at best a three peak approach. In this model, the Fed is given responsibility for regulating monetary policy, acting as lender of last resort and setting prudential requirements for firms. The second body would resemble a FSA-type institution for the U.S., with responsibility for regulating market conduct as a whole and the safety and soundness of institutions and possibly investor protection. A third peak may be created if the regulation of investor protection is considered appropriate for a separate agency.[171]

- Proposal 3—combine various sectorally equivalent regulators at the state and federal level into consolidated agencies, such that there is one agency for regulating securities, banking, insurance, etc. This model represents a consolidation of sectoral regulators rather than a more objectives-based approach to regulation and supervision.

- Proposal 4—create a separate agency for the regulation of systemically important institutions. Such a model is constructed so that such institutions receive "full service" supervision within one agency, while a more fragmented, sectoral approach continues in respect of the remaining firms.

In addition, the Treasury has recently set out a further design for reform:

[169] U.S. DEP'T OF THE TREASURY, *supra* note 51, at 13-14; Press Release, U.S. Dep't of the Treasury, Treasury Outlines Framework for Regulatory Reform (Mar. 26, 2009).

[170] *Id.* at 7-8.

[171] COMM. ON CAPITAL MARKETS REGULATION, RECOMMENDATIONS FOR REORGANIZING U.S. REGULATORY STRUCTURE (Jan. 14, 2009).

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- Proposal 5—introduce a degree of greater consolidation and centralized focus in the current regulatory structure, whilst leaving much of its functional composition intact. This appears to be the general model adopted in the Treasury's 2009 reform plan, which has provided a basis for the formulation of bills put forward by the House (the Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173) and the Senate (American Financial Stability Act of 2010). The 2009 plan seeks to increase the visual coverage over the market and centralize some oversight, particularly for the supervision of systemic risk arising from the operations of the large multi-function financial firms. The 2009 plan gives the Fed consolidated supervisory and regulatory responsibility over all large, interconnected institutions deemed to be systemically important, irrespective of whether or not they may be a bank, or include a bank in their corporate group.[172] The Fed is designated as the point provider of prudential regulation and supervision for all such entities.[173] In addition, to assist the Fed in its task, as well as more broadly to bridge some of the gaps left by the fragmented lattice of regulators, the Treasury contemplates the creation of a new Financial Services Oversight Council,[174] bringing together key supervisors, roughly in the mold of the PWG, to identify and tackle emerging risks, share information, and keep the Fed abreast of possible systemic developments.[175] Further evidence of increasing consolidation comes in the plan to fold the OCC and the OTS to establish a National Bank Supervisor, responsible for the chartering, supervision, and prudential oversight of national banks, thus eliminating the thrift charter and thrift holding companies. The FDIC, the Fed, and the NCUA, however, would retain their

[172] U.S. DEP'T OF TREASURY, *supra* note 156, at 20-23. In negotiations over reform, some lawmakers expressed reservations over giving the Fed expanded authority, as envisaged by the 2009 design, seeking instead to reign in the sphere of the Fed's power and restrict its oversight to matters of monetary policy only. Indeed, in November 2009, Senator Dodd had favored stripping the Fed of all bank supervision duties before modifying this position in the Senate's 2010 proposals. *See* SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, RESTORING AMERICAN FINANCIAL STABILITY-DISCUSSION DRAFT (Nov. 10, 2009), *available at* http://banking.senate.gov/public/_files/AYO09D44_xml.pdf.

[173] U.S. DEP'T OF THE TREASURY, *supra* note 156, at 22.

[174] The House and Senate bills both also contemplate a similar body to monitor systemic risks with a view to better spotting risks and assuring adequate capital and liquidity reserves for systemically important financial institutions.

[175] U.S. DEP'T OF THE TREASURY, *supra* note 156, at 19-20.

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existing spheres of authority over state chartered banks and credit unions.[176] However, despite this consolidating drive, the 2009 plan works to add new agencies to the present jigsaw without necessarily rationalizing and consolidating authority in their hands. In addition to the Oversight Council, the proposals include the establishment of an Office of National Insurance within the Treasury, to generally gather intelligence and monitor the operation of state-supervised and regulated insurance companies.[177] Most contentiously, the 2009 plans propose the creation of the Consumer Financial Protection Agency (CFPA), a dedicated agency to act as the key regulatory and supervisory player for protecting consumers of credit, savings, payment, and other financial services products. The CFPA however, far from being the main player in this area, will slot into a regulatory theater with many moving, indeed overlapping, parts. Notably, investor protection is left in the hands of the SEC and the CFTC,[178] and oversight of insurance contracts remains with state regulators. While ceding much of its jurisdiction to the CFPA for consumer protection in financial services, the FTC stays in play as a "back up" authority where it presently acts as well as retaining its existing authority over matters of fraud in the financial markets, with the CFPA having a "back up" role in this regard![179] Completing the picture, the Department of Justice will keep independent authority to prosecute infractions of consumer protection legislation. And, it goes without saying, state consumer protection laws will also figure in any analysis of the regulatory regimes that firms may be subject to in this area.[180]

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[176] *Id.* at 32. The Senate and the House proposals diverge somewhat from the Treasury's in their allocation of supervisory and regulatory responsibility in this area. For example, the Senate as proposed that the Fed retain oversight of bank holding companies with $50bn or more in assets, with smaller banks currently under the Fed's oversight being supervised by other regulators, notably the OCC and the FDIC.

[177] *Id.* 39-40.

[178] It is argued that a distinction between investors and consumers is one that is tenuous at best and likely to lead to an unevenness in the application of consumer protection standards between the CFPA, the SEC, and the CFTC. For example, some products (e.g. certain types of annuities) may straddle the jurisdictional dividing lines between these regulators which is likely to lead to possible regulatory arbitrage between offerors of financial services products and consumers, leaving consumers to face uncertainties as to how and through whom they may best enforce applicable rules.

[179] U.S. DEP'T OF THE TREASURY, *supra* note 156, Part III.

[180] It should be noted that, at the time of writing, the creation of the CFPA remains a matter of considerable uncertainty, with political sides pushing each way as part of congressional wrangling over the wider package of financial services reform. While the House contemplates the establishment the CFPA in the Wall Street Reform and Consumer Protection

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In addition to the complexities already involved in the determination of an optimal regulatory structure, the financial crisis added further layers of complication to current configurations:

- First, the operation of the Troubled Asset Relief Plan (TARP) brought the Treasury into direct contractual relationships with a number of financial institutions[181] that received TARP funds.[182] While there remains some uncertainty as to the extent to which the Treasury was able to dictate the terms on which such institutions conducted their banking and notably consumer lending business,[183] TARP term sheets imposed certain conditions for receipt of the funds (e.g. in relation to executive compensation).[184] As a result, although the Treasury could not be regarded as either a supervisor or regulator of these institutions, it nevertheless gained the ability to exert behavioral control over a large number of banking entities through the contractual connections generated under TARP to manage the use of emergency government funding. Further, the Treasury created control and monitoring capacity through its role as an investor in convertible preference shares and warrants in recipient

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Act (H.R. 4173), the Senate bill proposes housing a Consumer Financial Protection Bureau within the Fed with authority to supervise and regulate consumer finance products like credit cards and mortgages.

[181] Matthew Ericson, Elaine He & Amy Schoenfeld, *Tracking the $700 Billion Bailout*, N.Y. TIMES, *available at* http://www.nytimes.com/packages/html/national/200904_CREDITCRISIS/ recipients.html (Apr. 23, 2009).

[182] See U.S. DEP'T OF TREASURY, EMERGENCY ECONOMIC STABILIZATION ACT: CAPITAL PURCHASE PROGRAM CONTRACT TERMS (Mar. 6, 2009), *available at* http://www.treasury.gov/initiatives/eesa/.

[182] THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE, CREDIT AND LIQUIDITY PROGRAMS AND THE BALANCE SHEET, as updated.

[183] Press Release, House Comm. on Financial Services, Frank Releases Outline of Legislation to Amend TARP, (Jan. 9, 2009), *available at* http://www.house.gov/apps/list/press/financialsvcs_dem/press0109092.shtml; *see also* Open Congress, TARP Reform and Accountability Act (Jan. 21, 2009), *available at* http://www.opencongress.org/bill/111-h384/show.

[184] *See* U.S. DEP'T OF THE TREASURY, *supra* note 182. In addition, following the passage of the American Recovery and Reinvestment Act of 2009 (Pub.L. 111-5, H.R. 1, § 1), further restrictions have been placed on institutions that may be considering hiring non-U.S. citizens. Andrew Ross Sorkin, *A Hiring Bind for Foreigners and Banks*, N.Y. TIMES DEALBOOK, Mar. 10, 2009, *available at* http://dealbook.blogs.nytimes.com/2009/03/10/limits-on-visas-put-students-in-a-bind/.

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institutions, giving it an important position to observe if not participate in (for example, though conversion of its preference shares into common stock) the efforts by banks to raise capital to improve their balance sheets.

- Second, the capacity of the Fed to intervene in the management of systemic risk and financial stability was pushed into otherwise unchartered sectors of the market through the provision of credit lines and facilities designed to increase liquidity in the market. Acting under section 13(3) of the Federal Reserve Act, the Fed acted in ways virtually unprecedented, enlarging its balance sheet in a manner that has not been seen since its creation in 1914.[185] Indeed, it has been noted that the Fed, in previous crises, indicated an institutional resistance to act as an "all purpose agency" in the management of liquidity.[186] However, notwithstanding its relative insulation from the political process and the absence of electoral accountability, the Fed pushed more than a trillion dollars into the financial markets through, for example, loans to depository institutions,[187] investment in commercial paper issued by non-depository institutions and indirect investments in assets held by money market funds,[188] the provision of a non-recourse credit line to JP Morgan to guarantee up to $30 billion (with a deductible of $ 1 billion)[189] as well as the original $85 billion ($60 billion, under revised terms) loan to effect an emergency rescue of AIG.[190] Again, while the Fed should not be regarded as a new supervisor to the breadth of entities to which it provided emergency liquidity (apart from those which it was regulating previously), its provision of funding has nevertheless given it access to a variety of new constituents and the power to exert some control over the use of such funds, for example,

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[185] KENNETH N. KUTTNER, THE FEDERAL RESERVE AS LENDER OF LAST RESORT DURING THE PANIC OF 2008 1 (Prepared on behalf of the Committee on Capital Markets Regulation, for its May 2009 Report on the Global Financial Crisis) (Dec. 30, 2008), *available at* www.capmktsreg.org.

[186] *See id.* (comments of Alan Meltzer).

[187] BOARD OF GOVERNORS OF THE FEDERAL RESERVE, CREDIT AND LIQUIDITY PROGRAMS AND THE BALANCE SHEET: LENDING TO DEPOSITORY INSTITUTIONS (Jan. 13, 2010), *available at* http://www.federalreserve.gov/monetarypolicy/bst_lendingdepository.htm

[188] BOARD OF GOVERNORS OF THE FEDERAL RESERVE, CREDIT AND LIQUIDITY PROGRAMS AND THE BALANCE SHEET: OTHER LENDING FACILITIES (Jan. 13, 2010), *available at* http://www.federalreserve.gov/monetarypolicy/bst_lendingother.htm.

[189] Kate Kelly, *The Fall of Bear Stearns (Part III)*, WALL ST. J., May 28, 2008, at A1.

[190] Press Release, Federal Reserve System (Sept. 16, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/20080916a.htm; Press Release, Federal Reserve System (Nov. 10, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/20081110a.htm.

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in respect of repayment terms. In this regard, the Fed's considerable expansion of its liquidity facilities necessitates an assessment of how its position within the market's risk matrix should be conceived to determine how, if at all, its role might be affected as a result of its own exposures to the market.

- Third, as highlighted earlier in this paper, the financial crisis has exposed gaps in the exercise of oversight, with systemically implicated actors showing up into the fray from their relative invisibility. This was most clearly highlighted in respect of AIG and mortgage brokers and originators. Despite the stabilizing of the crisis in recent months, it does raise the issue of which actors may well have emerged as systemically relevant had the turmoil continued (e.g. service providers such as credit card issuers—often considered to be ineffectively regulated[191] could perhaps have flashed brightly on the regulatory radar in the event of a widespread default on credit card repayments, with repercussions in the secondary market holding securities backed by credit card receivables). Accordingly, in addition to the insurance and mortgage industry, the existing boundaries lines of regulatory oversight arguably requires thorough evaluation to better determine which actors may be considered as having a sufficient involvement in the financial markets to warrant supervision.

- Fourth, the financial crisis has also shed light on the global potential for economic turmoil, not simply through the operation of the securities markets, but also as a result of institutions with global operations. Accordingly, in light of shared concerns, it may be helpful to consider formalizing regulatory mechanisms for reaching international regulators to manage or otherwise preempt crises affecting particular pockets of the economy and internationally implicated institutions.[192]

Thus, the crisis provides the political and historical opportunity for undertaking a thoroughgoing reform of the regulatory system,[193] and actions taken

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[191] Jane Birnbaum, *Credit Card Overhauls Seem Likely*, N.Y. TIMES, July 5, 2008.

[192] This appears to have been taken on board in the 2009 Treasury Proposals. *See* U.S. DEP'T OF TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION part V (June 2009).

[193] *See, e.g.*, Skeel *supra* note 2, at 741-742; Richard Sylaa, *The 1930s Financial Reforms in Historical Perspective in* STABILITY IN THE FINANCIAL SYSTEM 13-14 (Dimitri B. Papadimitriou, ed.,

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to curtail its spread may well affect the shape that this reform agenda takes.[194] First, proposals for reform require to respond to and to take into account the regulatory implications of the steps taken by the Fed and the Treasury to manage the bailout that continue to cast a cautionary shadow over the market during the presently fragile recovery. Second, as set out above, the crisis has exposed the interconnections between sectors that may once have been considered functionally separate (e.g. the role of AIG in managing the risk on the books of banks and former investment banks), extending to cover banks, money market funds, AIG, and less traditional players such as non-depository issuers of commercial paper. This may make the move towards consolidated oversight not only more functionally logical but also highlights its particular relevance for the U.S. financial markets, which have thus far operated relatively unscathed under the fragmented structure discussed earlier in this paper. Third, while the proposals all set out some variant of the formations in which regulators should be deployed, the crisis seems to have drawn particular attention to the role of the Fed in taking wide-ranging and rapidly deployable action to contain systemic risks, such that the precedent that these actions have set—breaking away from the traditional parameters that the Fed had previously laid down for itself—as well as the credit risk that the Fed has absorbed in taking these steps,[195] arguably must be factored into the conception of a new regulatory design. Finally, the Treasury has also stepped into the spotlight by directing much of the bailout under TARP,[196] in addition to taking on a central role in decisions to determine the actions to be taken in respect of Bear, Lehman and AIG, amongst others. In this regard, although its ability to act as a financial regulator may be undermined by virtue of its lack of independence from political influences, its role in the crisis nevertheless demonstrated that centralized, coordinated action to deal with sectorally disparate financial institutions can be achieved, and further that it may perform a useful role in transition management, given its resources to link with a variety of financial institutions and government agencies across a multitude of sectors.

B. Towards a New Regulatory Framework

The proposals identified in the above section are motivated to

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Macmillan Press 1996).

[194] For example, the Scandinavian banking crises have been seen as having had an impact on the structure of integrated regulation adopted in those countries. *See* Michael Taylor & Alex Fleming, *Integrated Financial Supervision: Lessons from the Northern European Experience* 10 (World Bank Policy Research, Working Paper No. 2223, Sept. 1999).

[195] Kuttner, *supra* note 185, at 1-4.

[196] *See generally* http://www.treasury.gov/initiatives/eesa/.

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varying degrees by a consolidating imperative, but with different visions of how risk and burden should be distributed between regulators in the framework.[197] In the context of these proposals, this section discusses the key questions that require to be answered in the effort to outline an optimal structure for the oversight of financial institutions.

i. Regulating Systemic Risk and Managing Rescues

The financial crisis has identified a number of institutions considered to be "too big to fail." Their continuing operations have been safeguarded, often at considerable taxpayer expense, notwithstanding stricken balance sheets weighed down by large, indeed overwhelming,[198] volumes of illiquid "toxic" assets.[199] As seen during the crisis, these entities include not only banks like Citibank or Bank of America, but extend to other sectors (e.g. AIG, Bear Stearns and Lehman Brothers), with policymakers looking to broaden the categories of so-called systemically important organizations to include the larger hedge funds as well as clearing and settlement and payment systems.[200] Credit rating agencies have also been pointed to as important institutions that require more targeted, careful regulation.[201] In its 2009 proposals, the Treasury has called for the Fed, supported by the Financial Services Oversight Council, to act as the regulator of systemic risk within the market, overseeing all systemically significant institutions on a more consolidated basis and irrespective of the sectoral category to which such institutions belong. Such proposals replicate, to a degree, the supervisory regime in operation for the most complex financial institutions in the U.K.

As touched on briefly, notwithstanding the benefit of greater consolidation

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[197] In addition, for example, recommendations put forward by the report into financial stability recently published by the Group of 30's Working Group on Financial Reform that strongly endorse consolidation in financial supervision and regulation. GROUP OF 30, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY (Jan. 15, 2009).

[198] James Quinn, *Roubini Warns U.S. Banking System Effectively Insolvent,* THE TELEGRAPH, Jan. 20, 2009, *available at* http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/4299466/Roubini-warns-US-banking-system-effectively-insolvent.html.

[199] *See, e.g.,* David Enrich, *U.S. Agrees to Rescue Struggling Citigroup,* WALL ST. J., Nov. 24, 2008, at A1.

[200] See, for example, March 2009 Treasury proposals to bring certain hedge funds into the regulatory framework through registration, greater disclosure and information sharing. Press Release, U.S. Department of the Treasury, Treasury Outlines Framework For Regulatory Reform (Mar. 26, 2009). Similar proposals have been put forward by Rep. Barney Frank. *See* Kara Scanell, *Frank Backs Regulator for Systemic Risk,* WALL St J., Feb. 4, 2009, at C3.

[201] Scanell, *supra* note 200.

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in supervision and regulation of so-called systemically important entities, the move to introduce a systemic risk regulator as the key consolidating feature in U.S. financial services regulation reform misses the mark, side-stepping the possibility of a more thorough reorganization of the current framework.

First, overseeing systemically important institutions more intensively is a separate task from managing systemic risk within the market. Focusing on a number of established players, while leaving the mid-size or more niche outfits to oversight under the current model, might work to slow the spread of risks, but it does so without limiting their effect on entities that are subject to more fragmented supervisory practices. Indeed, such reform might simply dislocate the locus of risks away from the so-called systemically important players to other areas of the market or otherwise leave the smaller entities more vulnerable to the risks generated by bigger, embedded firms. Furthermore, risks generated by smaller, systemically-lesser players may not receive the attention necessary and could, as a result, potentially spread outwards. By way of example, Northern Rock does not easily fall within the category of a systemically significant institution, but the potential externalities generated by its operations could well have resulted in bank runs on similarly situated or even other, larger banks in the U.K.

This leads to the second point, discussed earlier, that there are serious issues in the definition of "systemically significant" institutions. While it may appear to be a straightforward category, it is nevertheless a problematic one. As discussed in Part III, the differing approaches to rescues of Bear and Lehman, are indicative of the impact of very fine-line judgments as to which institutions are in fact "systemic." Critically, systemically significant institutions may only emerge as being systemically significant in the event of a crisis, as new sectors are revealed in front-line roles in the market (e.g. AIG), such that the constituency and regulatory philosophy of a systemic risk regulator may be inherently unstable.

Thirdly, as suggested by the Committee on Capital Markets Regulation, designating certain institutions as systemically embedded risks creating moral hazard for those firms that receive this designation. Considering their positions in the market as being especially prized, market incentives to police risks are shifted from the institutions themselves to the regulator in charge, skewing risk management practices and arguably enhancing the market value of such institutions by dint of their special regulatory status.[202]

In view of the above, taking a functionally narrow approach towards consolidation and extending a unified regulatory umbrella to focus on certain "high-

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[202] *See* COMM. ON CAPITAL MARKETS REGULATION, *supra* note 171, at 8.

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value" firms may lead to the creation, in practice, of a "two-tier" field of supervision, with the so-called "smaller" firms left to fragmented, less complete oversight. In this regard, a deeper consolidation should be considered, taking into account the longer term proposals set out in the *Blueprint* and by the Committee on Capital Markets Regulation, together with the lessons learned through the financial crisis that underscore the point that smaller firms may be significant in the risks that they generate even if they do not, at first glance, stand out as particularly interconnected or influential in the market. Indeed, they may only come to be regarded as systemically visible when the risks they generate come to unexpected fruition in the heat of financial crisis.

Accordingly, as detailed below in this section, systemic risk regulation and supervision should be left to one or at best two regulators in respect of all regulated, financial firms. The natural candidates for this would be a consolidated market conduct regulator (as described in detail below), referred to in this paper as the "Financial Services Regulator" (FSR), and the Fed. The Fed, with existing responsibilities over financial stability and experience as banking regulator with oversight over bank prudential requirements, would take the leading role in setting out capital requirements and liquidity thresholds to control for safety and soundness and prevent the emergence of systemic risks.[203] This would leave the FSR to be the frontline supervisor for regulated firms to monitor compliance with the requirements laid down by the Fed. Nevertheless, taking into account the combustible nature of systemic and liquidity risks as well as the highly specialized skill involved in identifying the signs of such risks developing, it is advisable that the FSR and the Fed take a joint approach to tracking such externalities across the market, for example, through joint supervisory teams for firms needing special attention, a combined approach to developing rules in this area as well securing dialogue to avoid information asymmetries between the regulators. Taking a flexible and risk-based approach to oversight, focusing resources where they are most needed, more careful supervision of risky institutions can be deployed where appropriate, but with the regulatory gaze more intensively focused on systemic risk as a whole across the market, rather than on the institutions that are adjudged, correctly or otherwise, to be more actively responsible in its generation.

ii. The Key Actors in Rescues

A further aspect to this, high on the list of regulatory priorities, is to

[203] *Id.* at 5-6.

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determine how institutions should be bailed out and which regulators should be responsible in the event that a bailout is considered appropriate. This aspect of regulation may be more broadly construed to include an analysis of the provision of emergency assistance, as recently seen in the expanded liquidity support provided by the Fed, which provided assistance to a number of different, previously untouched sectors of the market, arguably extending its role as lender of last resort.

The current crisis has showcased the joint action of the Treasury and the Fed to support vast tracts of the economy through emergency support either under the TARP, in *ad hoc* rescues such as those of AIG, or through the Fed's unprecedented levels of emergency liquidity support.[204] Assistance has therefore been provided in a mix of congressionally authorized spending under TARP and through the Fed's authority pursuant to the Federal Reserve Act to secure financial stability as well as to act to provide crisis funds in accordance with section 13(3). Looking forward, an issue for debate is the extent to which the Fed should be involved in future bailouts, whether the Treasury should continue to be implicated and, eventually, the position of the FSR within this matrix.

First, until such time as the FSR can be established, the Treasury is likely to be a key player in this area. In view of the fragmentation across regulators, the Treasury can usefully act to coordinate information with respect to a failing entity. In addition, the Treasury can provide a route into the political process to secure Congressional agreement on policy positions with respect to particular regulatory spending programs. Following the introduction of the FSR, the FSR, as the main supervisor, would play the key role in information provision and in contributing to the broader decision to bailout an institution. While the FSR should be independent, it, alongside the Fed, can presumably access the political process through the offices of the Treasury, where necessary. However, as independent regulators, the FSR and the Fed are likely to enjoy discretion and latitude in decision-making in this area, which is highly desirable, in view of the expertise of these bodies as well as their privileged position with respect to information about an entity.

Second, there is a question mark as to the regulatory appropriateness and propriety of the Fed acting to provide a vast measure of liquidity support and taking on a large amount of credit risk in order to do so, as it has done in the current crisis. The Committee on Capital Markets Regulation has proposed a solution whereby the Fed is restricted to taking on only its lender-of-last-resort liabilities, with the

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[204] BOARD OF GOVERNORS OF FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE'S RESPONSE TO THE CRISIS (Jan. 27, 2010), *available at* http://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm.

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remaining credit risk (for example, assumed where the Fed has lent on the basis of sub-optimal collateral unacceptable in "normal" times, or provided exceptional liquidity support, as in its Commercial Paper Funding Facility) shifted to the Treasury and therefore directly taken on by the taxpayer.[205] This proposal is sound to the extent that it would free up the Fed's balance sheet, ensure that there is greater transparency in lending, and would make more explicit the depth of the credit risks that have been taken on. However, this Article foresees that emergency rescues by way of Fed-generated funding might be the most pragmatic, with governance concerns addressed through accountability mechanisms (e.g. a higher standard of disclosure) that are legislatively placed upon the Fed. As recent events have shown, action to provide assistance may need to be taken in very tight, time-pressured circumstances, requiring decision-makers to take rapid action with a good understanding of a distressed firm's business and the wider market in which it operates. Where politically charged situations are involved, as is likely to be the case if the Treasury is required to directly assume credit risk from a bailout, this may introduce political considerations that create pressure on regulators to make knee-jerk, politically palatable policy determinations, rather than those that may be better from the perspective of financial stability, safety and soundness and regulatory outcomes but that are otherwise unpopular with the public.

This being said, for accountability purposes, should Congress disapprove of Fed action, then it may take such steps to repeal or otherwise amend the Federal Reserve Act, as and when it considers it appropriate to do so. It has been proposed that these accountability measures may be further buttressed through additional tools in the hands of Congress: legislative movement is underway to make the Fed more transparent, notably through auditing of its various lending activities. [206]

Third, as detailed further below, upon the establishment of the FSR, responsibilities for supervision of the banking industry should shift to the FSR and out of the hands of the Fed. This is likely to give the Fed further independence with respect to its duties to secure market stability and monetary policy. In turn, this should be supported by the Fed retaining the principal role as liquidity provider (e.g. through open market operations) as well as lender of last resort, given the significant connections between the provision of such support and market stability.

Finally, regulators should seek to press ahead with a FDICA-type insolvency

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205 *See* COMM. ON CAPITAL MARKETS REGULATION, *supra* note 171.

206 *See generally* Federal Reserve Accountability Act of 2009, S. Res. 1803 (2009) (efforts by Senators Merkley and Corker under the proposed Act).

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for regulated financial institutions. An orderly procedure might reduce the need for emergency bailouts and stem systemic and liquidity risks by giving the market time to react to a firm's prospective distress and insolvency. This proposal has gained ground and is widely supported by regulators, notably the Treasury. In its 2009 proposals, a resolution regime would exist to service bank holding companies and financial holding companies.[207] However, notwithstanding its coverage of the large financial institutions, this regime should be made flexible with respect to its eligibility and be readily deployable to resolve a failing financial services firm as and when the intervention of an FDICA-type regime may be considered appropriate and helpful. Such a regime could usefully operate alongside a more consolidated regulatory framework, facilitated by better information flow between regulator and resolution vehicle, permitting the widest identification of financial services firms that may benefit from such intervention.

iii. The Role of the States

As set out earlier, Proposal 1 presents the most radical vision of a new regulatory model by bringing in one regulator for all financial services, subsuming all state and federal regulators into one body. It has been argued that such a regulator would be more effective in conducting oversight by increasing efficiencies to provide better supervision for financial conglomerates, greater safety for consumers, increased flexibility and elimination of regulatory gaps.[208] Under this model, consolidation is seen as bringing together the expertise of the various functional regulators at state and federal level into one organization, limiting duplications and permitting swifter reaction to unfolding crises through unified practices to manage regulation and supervision.[209]

However, this proposal would likely face a tremendous headwind to ever be seriously contemplated, given the political and philosophical commitment to assuring states' power in regulating financial services within their territories. As such, although the proposal provides a decisive break from the current model, the U.S. is culturally and politically too wedded to the federalist model to fully embrace a solution that completely bypasses regulation at the state level.[210] Although federalism in financial regulation currently produces an inconsistency in supervision

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[207] U.S. DEP'T OF THE TREASURY, *supra* note 156, at 76-78.

[208] Brown, *supra* note 30, at 94.

[209] *Id.* at 70.

[210] *See An American Perspective on the U.K. Financial Services Authority: Politics, Goals & Regulatory Intensity* n.7 (Discussion Paper No. 522, Aug. 2005), *available at* http://ssrn.com/abstract=839284.

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on certain matters,[211] state authorities are likely to have developed considerable knowledge in respect of the firms that they supervise and may be more attuned to local particularities. They may also be very efficient in their delivery of oversight in view of the more limited constituents under their watch, when compared with a large federal regulator. In this regard, states may play a useful role in informing regulator(s) at the federal level about the risk-profiles of firms, and this may carry special benefit for the U.S. given that it is geographically larger—and arguably more economically diverse – than the U.K. Further, states have developed expertise in certain regulatory areas, notably insurance or mortgage brokerage, and this should be seen as a positive in implementing the broader federal reform agenda going forward.

To ensure the successful merging of federal and state regulation, and to harness the expertise at all levels, debate is required to determine what duties states can have with respect to regulating financial services, in which areas and the extent of their regulatory power in addition to supervisory responsibilities. This debate has been largely neglected in the *Blueprint* as well as in the Treasury's 2009 proposals (with the exception of some discussion with respect to insurance oversight and the creation of an Office of National Insurance to gather information regarding the regulatory work of states in this area). However, in view of the risks that can arise at the state level and the potential for patchwork protection at the state level to undermine the effect of harmonized rules, bringing states within the fold of the future reform agenda seems to be especially pressing.

This Article suggests that reform measures will be unlikely to completely divest states of their power to regulate certain financial activities like insurance or mortgage brokerage.[212] State chartered institutions may well continue to operate in this context, such that there may be information regarding their activities and behavioral practices that are better known at the state level than at the federal level. Accordingly, a revised framework should incorporate a formal body that brings together state and federal regulators on a regular and systematized basis to discuss regulatory developments, specific cases and promote a more uniform interpretation and application of state and federal laws. It is argued that such a body is absolutely essential where state-federal divisions remain in regulation (e.g. mortgage brokerage and origination or indeed banking), otherwise federal and state

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[211] For example, the regulation of the insurance industry.

[212] Howell Jackson, *Learning from Eddy: A Meditation Upon Organizational Reform of Financial Supervision in Europe* 2 (Harvard Pub. Law Working Paper No. 09-17, Jan. 9, 2009), *available at* http://ssrn.com/abstract=1325510.

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regulators may each only have access to and an understanding of a disjointed picture regarding a firm's behavior. To ensure that turf issues do not undermine work, procedures should be put in place to provide that there is sufficient information sharing and cooperation between regulators at both the state and federal level. As seen in the arguments put forward in the Supreme Court case of *Cuomo v. Clearing House Ass'n*,[213] state-federal turf conflicts can potentially be explosive and mostly to the detriment of optimal oversight. In this regard, a state-federal charter, specifying rights and responsibilities between state and federal regulators should be helpful, particularly with respect to information sharing and dividing spheres of influence, in order to create a common enforcement approach and regulatory culture. While politically very difficult in the short-term, measures to clarify the states' role in supervision should be an intrinsic aspect of streamlining the regulation of financial services in the U.S.

iv. Allocations of Supervisory and Regulatory Responsibilities

This Article argues for greater consolidation of the U.S. regulatory framework. However, instead of the design outlined in Proposal 1, reform is recommended along the lines put forward by the Committee on Capital Markets Regulation and the Treasury's *Blueprint*, namely to move towards a multi-peaked model that divides regulatory/supervisory power and responsibilities across a very small number of organizations. This paper argues that the current moment of crisis provides a historically special opportunity to effect a powerful reform agenda, and this chance would be best taken rather than left for a later date, or subsumed within plans to effect a measure of consolidation, but without pushing forward a clear-cut unification of the patchwork of regulators at work in the U.S. financial markets. In this regard, the Treasury's 2009 proposals are somewhat reticent in their ambitions, and likely to create an even more confusing picture with the addition of several more agencies to the palette, limiting, in practice and in effect, the benefits of consolidation to a small group of chosen firms—creating a two-tier supervisory structure.

This Part briefly sets out this paper's conception of the optimal allocation of supervisory and regulatory responsibilities between key authorities, reflecting the particularities that have shifted the goalposts in the context of the current crisis and

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[213] 129 S. Ct. 2710 (2009). The case concerned the interpretation of the National Bank Act . The Attorney General of New York in 2005 had issued letters "in lieu of subpoena" to national banks requesting non-public information about the banks' lending practices. The OCC stated that its regulation promulgated under the National Bank Act precluded the State of New York from enforcing its fair-lending laws against the national banks. *See also* John Schwartz, *Bank Regulation Case Pits U.S. Against States*, N.Y. TIMES, Apr. 28, 2009, at B3.

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building on the discussions that have been set out in this Article for managing systemic risks and state-federal relations for future regulation.

The proposal in this Article envisages a move towards a multi-peaked rather than a unitary regulator in the mold of the FSA. The reasons for this are the following. First, the absence of regulatory competition, or at least the monopoly position that a single regulator holds, can affect the quality of oversight provided. As demonstrated in the case of the FSA, notwithstanding measures to create political accountability,[214] the prevalence of a single regulatory culture and means of operation can render the regulator less aware of its own failings. A small set of regulators can build checks and balances within the oversight framework to prevent a culture of regulatory complacency and unaccountability as well as better ensuring that key regulatory objectives are institutionally safeguarded rather than subsumed into one regulatory culture. Second, as has been argued in respect of the FSA, a single regulator may find itself overseeing a number of constituencies with potentially conflicting interests. Accordingly, a full-service authority may be prone to defending too many competing interests, such that issues of confidentiality, maintaining clear regulatory objectives, and setting effective and economically sound precedents, can make the task of taking a stance on the balance to be struck between such interests difficult.[215] This may potentially impact the ability of a single regulator to properly manage agency risks that could arise between consumers of financial services and firms – as it will be responsible for supervising both consumer protection and financial services provision. Accordingly, having a small set of separate agencies to manage different regulatory goals may limit the emergence of dominating special interests, providing a greater diversity of opinion on emerging risks and operating practices. It may also be important to establish the source of funding for agencies to circumvent charges of regulatory capture to particular interest groups, an issue that had particular resonance for the U.K. FSA in light of its supposedly "light touch" approach to regulation and its policy to operate on the basis of fees received from the financial institutions that it supervises.[216] Finally, although the operation of the

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[214] Notwithstanding its status as an independent agency, there are a number of mechanisms that have been put in place to ensure that the FSA is held accountable, with a view to ensuring that it meets its statutory objectives. For example, the FSA is obliged by FSMA to report to Treasury Ministers every year in relation to its conduct and through the Ministers to Parliament. For a more detailed description of this and other procedures in place to hold the FSA accountable, see Financial Services Authority, *supra* note 57.

[215] Vivek Ahuja, *FSA Chief Rebuffs Conflict of Interest Claim*, E-FIN. NEWS, Dec. 16, 2008, *available at* http://www.efinancialnews.com/homepage/content/3452804297/restricted.

[216] However, commentators have supported the policy of funding a regulatory

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U.K.'s tripartite committee has shown that there may be considerable difficulties in coordinating even a small number of agencies, a multi-peaked arrangement is unlikely to overburden a coordinating agency (e.g. the Treasury) should proper systems be in place to ensure concerted action. Accordingly, with proper interaction and contact between agencies in a multi-peaked structure and procedures that keep boundaries within their work fluid, this regulatory system benefits from a degree of specialized oversight without the disadvantages of serious structural impediments that keep these agencies from working effectively together.

a. Regulation of financial stability and monetary policy

The Fed is the proper body to be charged with the management of financial stability and monetary policy. To provide for greater independence, it will lose its supervisory authority over bank holding companies, the smaller banks that it supervises, and financial services holding companies, shifting these to the FSR. Its regulation and supervision of a specific sector of firms can arguably create a conflict of interest between the Fed's duties in respect of managing financial stability and monetary policy and any duty of care that it may owe to specific constituencies of firms qua supervisor. As a regulating and supervising body, the Fed is unlikely to wish upon itself the reputational consequences that may arise from the failure of its charges. So, to protect its institutional independence,[217] a reduction of such conflicts of interest would seem desirable.

That being said, in light of its expertise on matters of prudential and risk regulation, this Article proposes that the Fed act as regulator to make rules in respect of capital and liquidity requirements to manage externalities for the market and regulated firms, with the FSR supervising - institutionalizing an important regulatory objective.[218] As a system-wide regulator, the Fed would make prudential rules for assuring the safety and soundness for all types of financial services firms that may pose risks and thus be required to take steps to mitigate those risks through appropriate reserves of capital and available liquidity. In this regard, it is likely to need to broaden the scale of its expertise but, divested of its supervisory responsibilities to one specific sector, it may eventually develop deep reservoirs of information on the system as a whole rather than having more concentrated

agency on the basis of fees received from supervised firms. This is seen as a way of providing for a budgetary autonomy and ability to allocate resources in accordance with agency practices rather than government mandates and constraints. *See* R.K. Abrams & M.W. Taylor, *Issues in the Unification of Financial Sector Supervision* 6 (IMF Working Paper WP/00/213, Dec. 2002).

[217] JOINT ECONOMIC COMMITTEE, *supra* note 93.

[218] LLEWELLYN, *supra* note 10, at 15-19 .

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knowledge of just one part of it.

b. Market conduct:

As per other proposals in this area, a revised framework should include a market conduct supervisor that regulates and supervises the safety and soundness of firms and their conduct. It is suggested that the regulator —the FSR—be independent, with a mandate for creating and making rules to regulate and supervise firms, except for prudential and liquidity regulation, where responsibilities should primarily lie with the Fed. Broadly, the market conduct regulator would be responsible for the admission of firms into the financial market, taking into account their business activities and financial product offerings. Additionally, the market conduct supervisor will oversee the management structure of firms, be aware of their operational readiness to enter the market, and take an active role in clearing their lead personnel for qualifications and competence in their jobs. Critically, this regulator will regulate and supervise conduct of business rules for the market, thereby bringing in a consumer and investor focus (however, see below). It shall oversee the proper compliance of firms with customer-specific rules (e.g. in respect of financial promotions to unsophisticated investors), disclosures, fraudulent or improper conduct towards customers, market manipulation, and insider trading. Going forward, exchanges as well as clearing and settlement mechanisms should be brought within its supervision, including any new mechanism to bring CDS and formerly over-the-counter credit derivatives more clearly into the daylight through mandatory clearing or trading on exchange.

As stated by the Committee on Capital Markets Regulation, the Fed is likely to require access to information regarding the prudential make-up of firms to best provide for its lender-of-last-resort duties.[219] So it may be considered prudent for lines of communication between the Fed and the FSR to be open at all times and reinforced through information sharing mechanisms that allow joint access to reduce the incidence of information asymmetries and ensure that risk can be properly monitored.

Taking into account the current crisis and the lessons that have been learnt from it both in the U.S. and in the U.K., it is of particular significance that the market conduct regulator be internally organized in a way that corresponds to the architecture of the market. This may involve more less sector-based regulation and a greater focus on an objectives-based approach to supervision and regulation, taking

[219] COMM. ON CAPITAL MARKETS REGULATION, *supra* note 171, at 9.

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into account the amalgam of activities that are conducted by firms, the ways in which these then connect with those carried out by other players in the market, and how the market as a whole is then affected. Multi-functional firms can be supervised by teams that can bring together the expertise in various sector-based areas to reflect the individual risk and market profile of a supervised firm. Where firms are seen as single-function firms, they may be supervised with a greater degree of sector-based oversight, but with an understanding how their activities connect to the activities of other types of actors and into the market more broadly.

c. **Consumer protection:**

The deleterious effect of a lax consumer protection regime on the market and the economy more broadly has become glaringly evident in the course of the crisis. Reckless and predatory lending practices and a market that generously rewarded the fruits of the risks taken, provided a platform from which the crisis eventually accelerated deeper into the economy. Accordingly, echoing the Treasury's 2009 proposals, it is critical to ensure stronger consumer protection as part of the financial services reform agenda.

This Article proposes that a revised regulatory framework include an independent, dedicated consumer watchdog for financial services. While the role may be performed by the FSR, a separate agency focused on monitoring the proper application of and adherence to consumer protection standards may keep the FSR and the Fed more actively mindful of consumer interests. However, in contrast to the regulatory and supervisory powers given to the CPFA in the Treasury's 2009 proposals, the consumer protection agency, should have supervisory, rather than rule-making or enforcement authority. To ensure that there be a common enforcement culture, responsibility for regulation and implementation of consumer protection rules may be housed within the FSR. While the CFPA will sit alongside a number of agencies in the conduct of its function, notably the SEC, the CFTC, and insurance regulators, this Article does not make any distinction between consumers and investors in financial services, arguing that such distinctions are not only artificial but likely to subject consumers to arbitrarily different standards of protection. Instead, it is suggested that a consumer protection agency work to oversee consumer protection issues affecting the market as whole, complementing the FSR in the application of robust consumer protection standards. Although, regulation and enforcement of consumer protection standards may take a second-seat to market conduct within FSR, such that concerns regarding safety and soundness, market stability or indeed the interests of powerful supervisees may trump those of the consumer, the U.K's FSA has shown that this duality of function

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can be put into practice quite effectively, with consumer protection given considerable institutional weight in the hierarchy of regulatory objectives.[220] However, with the addition of a dedicated agency to raise consumer protection concerns and monitor application of standards, the FSR may be kept properly mindful of the regulatory objective to better safeguard consumers against exploitative and harmful behavior by financial services players.

V. Consolidation – Points to Consider

In this Article, consolidation is viewed as more than simply desirable, given the gaps in regulation that have been created, the inconvenience and strain of duplicative rules for the industry, and the fiction promoted by a system that normatively parses the financial markets down sectoral lines. At the same time, difficulties have also prevailed within the U.K.'s highly consolidated regulatory model. This Article argues the regulatory lapses evidenced in the financial crisis as reflecting a basic failure in oversight that would likely have happened irrespective of the model adopted, although its pathway may have been made easier by the fragmented system in the U.S. or perhaps been less easy to spot by the single regulator in the U.K.

Dismissing the consolidation/single regulator model on the basis of the FSA's performance in the crisis[221] would be myopic, but the FSA's behavior and that of the tripartite committee does provide some insight into the potential pitfalls inherent in the consolidated framework, such that to consider it as a fix-all for a broken system may be somewhat optimistic.

First, a consolidated framework may require more effort to create greater clarity in the identification of objectives[222] to provide for an internal organizational structure that properly reflects the structure of the market and its regulatory needs. This Article suggests that regulatory design place the rationales of regulation at the center of its structure, working around these to establish the architecture, provisions, processes and procedures for supervision and regulation. However, a set of core goals does not necessarily eliminate the potential for intra-agency friction in the case

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[220] REGULATING FINANCIAL SERVICES AND MARKETS IN THE 21ST CENTURY 154 (Eilis Ferran & Charles Goodhart eds., Hart Publishing 2001); *see also* Hal S. Scott, *Regulatory Reform Needs a Re-think*, Sept. 25, 2009, *available at* http://www.law.harvard.edu/news/2009/09/25_scott.html.

[221] *See* CONSERVATIVE PARTY, FROM CRISIS TO CONFIDENCE: PLAN FOR SOUND BANKING (July 20, 2009) (the knee-jerk response by the U.K. Conservative party to diminish or indeed entirely abolish the FSA, handing over the FSA's authority to the Bank of England).

[222] Abrams & Taylor, *supra* note 216, at 15, 17.

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where competing objectives are involved and regulators are required to determine which should be prioritized. There is also a danger that consolidation results in simply bringing various functional regulators together without really fusing objectives on a cross-sectoral basis, such that old organizational and sectoral divisions persist, but within a nominally unified umbrella. While this may suit certain regulators, it is suggested that it misses the opportunity afforded by consolidation to create a more unified and big-picture understanding of the market, institutionalizing an approach to regulating different types of institutions that applies common principles to identify risk, investor protection concerns, information requirements and market impact, without fixating on the functional categories to which an institution belongs. In relation to the FSA and Northern Rock, notwithstanding consolidation, much of the supervision was undertaken on the basis of internal sectoral divisions, resulting in the firm being shunted to an inappropriate desk that did not fully appreciate the risk that Northern Rock was taking on its books. Such a methodology can not only create allocation problems, but it can also fail to effectively harness the expertise that different experts within a single regulator bring to the composite understanding of a firm's behavior.

Second, another shortcoming of consolidation maybe that by extending its authority over a number of financial industries and firms, the regulator may lose in depth what it gains in its breadth of oversight. The logistical task of identifying expertise among personnel and applying this consistently to the supervision of all firms may be difficult to achieve, such that some are better and more thoroughly supervised than others. In some instances—for example where supervision is conducted on the basis of risk, such that systemically significant institutions receive closer attention—this may be quite appropriate. But this can also leave vulnerabilities within the market, where firms that are perhaps less than systemic but nevertheless significant in their activities are left to varying intensities of supervision. Related to this is the point that the consolidated model risks sowing moral hazard by leading different constituencies of firms and investors to expect an equal level of treatment and protection,[223] for example with investors in money market funds coming to expect the same or similar protection given to bank depositors. Accordingly, consolidated supervision and regulation may come to generate the expectation of common standards of oversight being applied across different areas of the market and, given the likely breadth of its activities, it is probable these may be difficult or indeed impossible to meet.

Third, the crisis has highlighted the critical place of risk analysis in the

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[223] *Id.* at 19-20.

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supervision of financial institutions and difficulties involved in catching its accumulation where a number of regulators are involved. However, risk may also develop where responsibility for oversight sits within one or two organizations, for example, if authorities poorly implement the objectives they have been tasked to apply. If regulators fail, their mistakes are arguably intensified where these are made within a consolidated framework, given the potential for market-wide impact and a likely absence of organizational checks and balances.[224]

This raises the issue of the optimal means for creating accountability within a consolidated regulatory system, where the emphasis may be—as with the U.K.'s FSA—to create an independent body with a good degree of insulation from the political process. While some commentators have suggested that consolidated regulators may be more careful and self-critical as the buck generally stops with them,[225] others are more circumspect, suggesting that concentrations of power can be detrimental to accountability.[226] Accordingly, a consolidated regulatory structure may require careful thought to determine how best to create accountability without undermining regulatory independence. In this Article, a multi-peaked approach has been proposed with a view to creating some intra-regulator tension to improve standards through the establishment of structural checks and balances, though accountability issues are likely to persist in any event. Finally, it may be argued that this crisis provides an opportunity to assess the operating premises of the Fed and how it can be better held accountable given its powerful and unprecedented intervention during the crisis.

VI. Conclusion

The seeding and spread of the financial crisis within the U.S. and U.K. economies has exposed the inner workings of their respective regulatory systems, in each case highlighting the various shortcomings that may be seen to have contributed to the development of market turmoil. The outdated and strained U.S. regulatory system—divided many times along sectoral and state lines—has long been considered unsuitable for the increasingly integrated market in financial services that it is charged with overseeing. This has given commentators further ammunition to promote the consolidating objective with a view to bringing in—at least at the federal level, if not more deeply—agencies and regulators into one or

224 Ferran, *supra* note 69, at 280.
225 *Id.*
226 GOODHART, *supra* note 5, at 153-154.
226 GOODHART, *supra* note 5, at 153-154.

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maybe a few bodies to oversee the market.

This Article argues that neither system prevented failures in oversight. However, the conduct of regulators in this crisis has provided clues as to the shape and design of regulatory models that may be well placed to detect and deal with future market turmoil in a manner that is prompt, effective, and conscious of the broader implications of regulator action. This Article suggests that reform take place to consolidate the U.S. regulatory structure into a multi-peaked framework. Most critically, the central place of regulatory objectives must be reasserted, reevaluated, and reinserted into the new structure to promote a consistency and unity of regulatory purpose. Recent steps taken by the Fed and the Treasury to steady the markets through bailouts and the supply of liquidity may have inadvertently introduced the market to concerted action by a small number of state actors to act to control and connect with various institutions, irrespective of their functional categories, potentially setting the scene for more formal and thoroughgoing reform. Nevertheless, it is proposed that each step in this direction be purposefully yet prudently taken, with a clear eye towards the mistakes already made, to ensure that the seeds of the current crisis are not left to germinate in the structures constructed to bury them.

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