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FINANCIAL REGULATION REFORM: MAINTAINING THE STATUS QUO

*James A. Fanto**

INTRODUCTION

We have been living through one of the worst financial and economic crises since the Great Depression. Several storied financial institutions collapsed or disappeared through mergers, in the space of weeks. Major banking conglomerates Citigroup and Bank of America, and the largest insurance conglomerate, American International Group, remain in trouble and have been propped up by massive government aid. The federal government had also to assume control of the government sponsored entities, Fannie Mae and Freddie Mac, which are financial institutions that fund home mortgages. In the crisis, financial firms essentially stopped financing consumer and commercial activities because of concern over their own solvency and that of their counterparties; this situation of systemic risk in turn led to a severe economic downturn. When the financial system and the economy stopped functioning, the federal government provided emergency capital to financial firms and instituted programs to take troubled assets off of their books, and additionally instituted a stimulus to kick-start the economy.

The initial and emergency government legislation was spearheaded by the Bush Administration and was then continued by the Obama Administration.¹ However, amid the financial and economic chaos, there were

* Professor of Law, Brooklyn Law School. © All Rights Reserved. I would like to thank the participants in the two conferences where this Article was presented for their comments on it: Brooklyn Law School Dennis J. Block Center for the Study of International Business Law Symposium, New Paradigms for Financial Regulation in the United States and the European Union (2009); Centre for Commercial Law Studies, Queen Mary School of Law, University of London (2009).

1. See Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008) (“EESA”). EESA established the Troubled Asset Relief Program (“TARP”) that gives the U.S. Treasury the authority to purchase or guarantee up to \$700 billion in troubled assets held by financial institutions. Under the authority of EESA, the Treasury established the Capital Purchase Program, which allowed it to provide direct capital support to financial institutions. When the Obama Administration took over in 2009, it continued the approach of shoring up the capital positions of major financial conglomerates. Moreover, the Treasury instituted the “Financial Stability Plan” to put financial institutions and the financial system back on a sound footing. See *U.S. Dep’t of the Treasury*, <http://www.financialstability.gov> (last visited Apr. 1, 2010) (describing the plan’s projects). This plan included a program of continuing to provide capital to financial institutions (now renamed the “Capital Assistance Program”) and to “stress test” the largest, most systematically important financial institutions to ensure that they had enough resources to weather the crisis. For the stimulus legislation that the Obama Ad-

clearly problems in financial institutions and with financial regulation that had contributed to the massive crisis; these would take considerable time and thought to address. After over nine months in office, the Obama Administration finally proposed a reform plan for the financial system (the “Plan”), the implementing legislation of which is working its way through Congress.² I contend that, in its initial outline, the Plan let pass a unique opportunity to address the failings of finance and financial institutions that contributed to the current crisis and that will generate future financial cataclysms. The Plan does this by maintaining the existence, and emphasizing the importance, of the large diversified financial conglomerates that are engaged in an array of financial activities and that typify modern finance. At most, it extends regulation to the “shadow banking system,” i.e., the financial institutions, like hedge fund groups, that are the unregulated counterparts to the financial conglomerates. The obvious question is why the Plan does not propose significant reform of the financial conglomerate itself. Like others, I believe that this administration, just as other administrations before it, has been “captured” by finance in a complex, ideological way.³ However, as Congress has been debating and revising the legislation implementing the Plan, the Administration and financial regulators have adopted a more critical stance towards the financial conglomerates. This may suggest that fissures are beginning to form in the dominant ideological straightjacket concerning finance and financial conglomerates that has constrained the views of senior policy-makers in recent years.

The Article proceeds as follows. Part I briefly outlines the story of the triumph of finance over the last three decades, which has been accepted by senior policy-makers and regulators, and the creation and dominance of the large financial conglomerates. It then contrasts this story with an alternative account of the harms caused by finance and the conglomerates. Part II explains how several proposals in the Plan—its enhancement of the power of the Board of Governors of the Federal Reserve System (the “Federal Reserve”), its reform of risk management, and the establishment of a consumer financial protection agency—reinforce the dominance of financial conglomerates in our financial system and the significant risks that such dominance poses to the system and the econo-

ministration proposed and saw enacted, which included regulation of compensation in financial firms receiving government aid, see American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009) (“ARRA”).

2. See DEP'T OF THE TREASURY, A NEW FOUNDATION: REBUILDING FIN. SUPERVISION AND REG. (2009) [hereinafter A NEW FOUNDATION].

3. See, e.g., Simon Johnson, *The Quiet Coup*, THE ATLANTIC ONLINE (May 2009), <http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/7364/>.

my. Part III outlines an alternative approach that would counter the power of, and put an end to, the financial conglomerates. This approach includes removing government support from the large financial firms while providing bank regulators with the power to place the conglomerates into conservatorship and receivership. This Part also explains why the Obama Administration's preference for incremental reform of the financial conglomerates will not succeed, because the firms will control and thus undermine the reforms. Part V concludes.

I. BACKGROUND

A. *The Triumph of Finance*

The last two decades of the 20th century and the first decade of the 21st century represent a triumph of finance, at least until the current financial crisis.⁴ First, during this period, there has been a tremendous growth in theoretical and empirical understanding about financial institutions, markets, and instruments. To name just a few examples, one thinks of the theory of efficient markets and the related concept of optimal investment portfolios, the financial and disciplinary value of debt, and the understanding and pricing of options. This understanding partly responded to demand: during this period, massive amounts of funds flowed into the financial sector from individuals who had to pay for their retirement from their own investments.⁵

As the story goes, finance triumphed because it benefited ordinary citizens and businesses, and thus the larger economy. It made investing scientific, primarily by offering strategies to deal efficiently with risks. For example, investors were taught that they could create a diversified portfolio that would eliminate many of the risks associated with investing in securities and that would be cost efficient.⁶ They were also offered a wide, and sometimes bewildering, array of financial instruments (chiefly derivatives) to address other risks in an investment portfolio. Moreover,

4. For a scholarly account of this transformation, see ROBERT J. SHILLER, *THE NEW FINANCIAL ORDER: RISK IN THE 21ST CENTURY* (2003). For a journalistic account, see JUSTIN FOX, *THE MYTH OF THE RATIONAL MARKET: A HISTORY OF RISK, REWARD, AND DELUSION ON WALL STREET* (2003).

5. See *e.g.* STEVEN A. SASS, *THE PROMISE OF PRIVATE PENSIONS: THE FIRST HUNDRED YEARS* 252 (1997).

6. The diversified risks would eliminate the unsystematic risks associated with individual securities, leaving for investors only the fundamental risks associated with all securities. See *generally* BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* (1996). This insight spawned the index fund, made famous by Vanguard. See JOHN C. BOGLE, *THE BATTLE FOR THE SOUL OF CAPITALISM* 139–214 (2005).

finance gave firms new ways to think about capital structure and numerous tools to deal with their risks (again, derivatives).⁷ Finance also espoused agency theory and, as a result, provided new perspectives on firm governance, particularly to address longstanding problems of management.⁸ For instance, paying executives in stock options was based upon a financial assumption that the problem of managers acting contrary to shareholder wealth would best be solved if the interests of the two groups were aligned. Securitization, which sparked the current crisis, was also an invention of finance—it allowed persons to invest confidently in risky assets through a diversification strategy (i.e., the assets, such as home loans, were numerous, geographically diverse, and pooled).⁹

According to the story, finance benefited everyone. With the help of hard-edged financiers, American industry became more focused on its task of delivering wealth to shareholders as it embraced the lessons of finance.¹⁰ Ordinary investors found that they were no longer limited in their choice of investments, for now they had an array of old and new financial products to pick from, depending upon their preferences and investment goals.¹¹ Significantly for the purposes of evaluating the causes of the crisis, almost any consumer could take advantage of financial products that allowed him or her to purchase homes and consumer goods and that could be tailored to meet the consumer's personal circumstances.¹²

The U.S. financial industry became one of the most significant sectors in the country and the envy of the rest of the world. It grew significantly,

7. See JAMES C. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 258–86 (10th ed. 1995).

8. See, e.g., MICHAEL C. JENSEN, *FOUNDATIONS OF ORGANIZATIONAL STRATEGY* 51–102 (1998).

9. Securitization, or structured finance, is simply the process whereby long-term receivables, such as loans, are transformed into securities. This occurs when the receivables are pooled in a legal vehicle and securities (generally debt) are issued on the basis of the pool. For example, an investor who would be reluctant to fund one home mortgage can purchase debt securities whose payment of principal and interest is funded by thousands of home mortgages on properties throughout the country. See generally Dwight Jaffee et al., *Mortgage Origination and Securitization in the Financial Crisis*, in VIRAL V. ACHARYA & MATTHEW RICHARDSON, *RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM* 61, 68 (2009).

10. See GEORGE P. BAKER & GEORGE DAVID SMITH, *THE NEW FINANCIAL CAPITALISTS: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE* 91–123 (1998).

11. See ROBERT E. LITAN & JONATHAN RAUCH, *AMERICAN FINANCE FOR THE 21ST CENTURY* 161–81 (1998).

12. On the growth in mortgage loans prior to the crisis, see Jaffee et al., *supra* note 9, at 61–82.

occupying an increasing share of the gross domestic product and employing large numbers of people, particularly from elite educational backgrounds.¹³ The paradigm of the financial industry was the financial conglomerate, which combined financial sectors such as commercial banking, investment banking, and insurance. Since all financial institutions deal with investment and risks, it seemed to make sense to create an institution that offered the full array of financial products and services.¹⁴ This conglomerate could be created only when legal restrictions dating from the aftermath of the Great Depression that separated commercial banking from other kinds of finance were finally changed to allow the linking of financial services.¹⁵ Participants in the financial services industry became wealthy as a result of the triumph of finance, but this outcome was justified (so the story went), for they were receiving their share of the wealth and benefits that they produced for the country.¹⁶

B. Another Perspective on Finance

There is another story of modern finance than this one of unalloyed benefits—and the financial crisis has brought this alternative account to the foreground. Without entering into longstanding debates, I contend that there is a valid argument that the financial industry destroyed, rather than improved, many companies and industries under the guise of financial rationalization.¹⁷ Financial specialists took control of companies, saddled them with debt, and ensured that—through fees, dividends, and other payouts—the specialists would be enriched no matter the ultimate fate of the firms. Finance’s view of the firm as a financial puzzle for value maximization was adopted by company senior executives, who participated in going private or sales transactions. Executives also embraced the finance model of stock option-based compensation, which allowed

13. It is reported that, before the crisis, the financial sector produced approximately 40% of U.S. corporate profits. See Johnson, *supra* note 3, at 4.

14. See LITAN & RAUCH, *supra* note 11, at 50–86.

15. For a brief discussion of these institutions and the legal background to their formation, see Anthony Saunders et al., Enhanced Regulation of Large, Complex Financial Institutions, in VIRAL V. ACHARYA & MATTHEW RICHARDSON, RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 139–56 (2009).

16. See generally Thomas Philippon & Ariel Reshef, *Wages and Human Capital in the U.S. Financial Services Industry: 1909–2006* (Nat’l Bureau of Econ. Research, Working Paper No. 14644, 2009) (arguing that during two periods in the last century, compensation in the financial industry has been overly generous compared to what the market can support).

17. See PHILIP AUGAR, THE GREED MERCHANTS: HOW THE INVESTMENT BANKS PLAYED THE FREE MARKET GAME 204–21 (2005).

them to propel their compensation into the stratosphere.¹⁸ Thus, rather than Wall Street being a service provider and thus subservient to the capital raising purposes of Main Street businesses, the roles were reversed, which contributed to a “hollowing out” of management and industry in this country.¹⁹

The story about the benefits of finance to ordinary investors and consumers is also less convincing now in light of the losses caused by the financial crisis. The crisis brought to the forefront new examples of the repeated practice of financial professionals pushing investors into investments that often have higher commissions and higher risks than were represented: auction-rate securities and collateralized debt obligations that lost significant value in the financial meltdown come to mind.²⁰ Moreover, the crisis resulted in staggering investment and household wealth losses, which might take years to recoup.²¹ In addition, many of the financial products that were offered to consumers proved to be toxic to them and eroded their household wealth, yet were a bonanza for the financial industry. For example, many consumers were sold loan products that were unsustainable in likely scenarios, e.g. when real estate prices failed to rise.²² Once again, finance offered consumers an illusion

18. *See generally* LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 159–73 (2004) (discussing stock option practices that have increased executive compensation without regard to performance). Executives also used tools offered by bankers to hedge their returns on this compensation or to benefit in other ways from their executive positions (e.g., to receive shares from other companies doing initial public offerings). *See* NORMAN POSER & JAMES FANTO, *BROKER-DEALER LAW AND REGULATION* § 13.07[H] (4th ed. 2007).

19. *See* LAWRENCE E. MITCHELL, *THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY* (2007) (explaining the shift from practical business improvements to market manipulation as stock came to be the driving force of the American economy over the course of the 20th century).

20. *See, e.g.*, POSER & FANTO, *supra* note 18, § 1.02.

21. *See* INTERNATIONAL MONETARY FUND, *WORLD ECONOMIC OUTLOOK: SUSTAINING THE RECOVERY* 68 (Oct. 2009). As an aside, financial professionals offer favored investors trading strategies to obtain “alpha,” which is based upon, among other things, inefficiencies and trading patterns in the market. According to finance theory, the sophisticated trading makes the market more efficient and thus ultimately beneficial to investors. Yet financial professionals spend an inordinate amount of time and effort, and reap significant profits, from this active trading based on market inefficiencies, which they conduct also for themselves as principals with high leverage. *See* JONATHAN A. KNEE, *THE ACCIDENTAL INVESTMENT BANKER: INSIDE THE DECADE THAT TRANSFORMED WALL STREET* 225 (2006). This suggests that, even when ordinary investors are not being pushed into expensive financial products, they are still passively investing in a market that is a profit source for the financial professionals.

22. *See generally* JOINT ECON. COMM., *THE U.S. HOUSING BUBBLE AND THE GLOBAL FINANCIAL CRISIS: HOUSING AND HOUSING-RELATED FINANCE* (2008).

of well-being with devastating consequences, such as personal bankruptcy, loss of credit scores, and other personal hardships.²³

Furthermore, as the financial crisis has shown, the financial industry (particularly through financial conglomerates) creates economic and social instability by its activities. As a result of their involvement in asset-backed securities and related derivatives, financial conglomerates, which control most of the financial assets in the country, had to be bailed out by the federal government in multiple and costly ways so that the financial system would not collapse and the funding necessary for basic economic functions would go on through these institutions.²⁴ The crisis created a risk of collapse of the financial system (known as systemic risk) and arrested economic activity, pushing the world economy into a significant recession.²⁵ The government support came at a significant cost to taxpayers, who themselves came to be the guarantors of the financial institutions. In other words, financial conglomerates made the economic situation in this country highly precarious, with consequences of job loss and personal devastation to many individuals, while the institutions were bailed out by the government.²⁶

Finally, rather than producing a society where all boats rise through wealth it creates, finance arguably has led to an economic system that is politically destabilizing. In the words of economist Simon Johnson, as a result of finance the United States is increasingly a “banana republic” with a financial elite that owns or controls most of the country’s wealth, a growing impoverished underclass, and a shrinking middle class that is threatened with falling into the second group.²⁷ This is a potentially unst-

23. See generally CHARLES R. MORRIS, *THE TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH* (2008).

24. The importance of these financial conglomerates as providers of basic financial services was the justification used by the Obama Administration for their preservation. See Timothy Geithner, Treasury Sec’y, Secretary Geithner Introduces Financial Stability Plan (Feb. 10, 2009), available at www.ustreas.gov/pres/releases/tg18.htm. This is why federal financial regulators conducted a stress test only on the nineteen largest U.S. financial institutions (it focused on banks with greater than \$100 billion of assets, which are two-thirds of holding company assets today). See U.S. DEP’T OF THE TREASURY, *FACT SHEET FINANCIAL STABILITY PLAN*, at 2 (Feb. 10, 2009), available at <http://www.financialstability.gov>; see also CONG. OVERSIGHT PANEL, *AUGUST OVERSIGHT REPORT: THE CONTINUED RISK OF TROUBLED ASSETS*, at 4 (Aug. 11, 2009).

25. See Viral V. Acharya et al., *A Bird’s-Eye View: The Financial Crisis of 2007–2009: Causes and Remedies*, in VIRAL V. ACHARYA & MATTHEW RICHARDSON, *RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM* 1–8 (2009).

26. The financial conglomerates and other financial institutions still hold troubled assets, which pose continuing problems to the institutions. See CONG. OVERSIGHT PANEL, *supra* note 24, at 3–4.

27. See Johnson, *supra* note 3.

able political outcome for a democracy, since, as seen in many Latin American countries, a country with such uneven wealth distribution is prone to slide into fascism, whether of the left or the right.²⁸ This movement into extreme wealth disparity corresponds with the last three decades of the triumph of finance.

II. THE OBAMA ADMINISTRATION'S FINANCIAL REFORM PLAN AND ITS LIMITATIONS

Given fundamental problems with the dominance of finance and with the financial conglomerates that constitute its paradigm, as outlined above, it is understandable that the initial Plan is a disappointment. The Plan preserves the status quo of large financial conglomerates and arguably even enhances their importance in the United States. It thus reflects a relatively positive outlook on finance and financial professionals, a position that strongly contrasts with the Administration's stricter attitude towards other nonfinancial industries that are experiencing trouble, such as the automobile industry. That is, even though financial firms brought the financial system to near collapse and the economy to its knees whereas the failure of automotive companies had no such systemic effects, the Administration initially took a supportive approach to the former and critical one to the latter.²⁹ Recently, however, Treasury officials and financial regulators, perhaps pushed by the growing criticism of the Administration's initial favorable treatment of financial conglomerates, have begun to be more critical of the conglomerates.³⁰

28. See, e.g., Johnson, *supra* note 3; *Too Big to Fail or Too Big to Save? Examining the Systematic Threats of Large Financial Institutions: Hearing before the Joint Econ. Comm.*, 111th Cong. (Apr. 21, 2009) (testimony of Simon Johnson, Professor, MIT Sloan Sch. Mgmt.).

29. For an outline of the Administration's support of the U.S. automobile industry, see U.S. DEP'T OF THE TREASURY, ROAD TO STABILITY: AUTOMOTIVE INDUSTRY FINANCING PROGRAM (Mar. 18, 2010), available at <http://www.financialstability.gov/roadtostability/autoprogram.html>. It is curious that the stated justification for the automobile rescue package is "financial market stability," but that reason has not prevented the government from allowing automobile companies to fail, although it has been reluctant to do the same for financial conglomerates.

30. This essay was written and revised in the latter half of 2009. Since that time, the Administration has become increasingly critical of financial conglomerates and has even made proposals dealing with limiting their size and activities. See, e.g., Press Release, White House, President Obama Calls for New Restrictions on Size and Scope of Financial Institutions to Rein in Excesses and Protect Taxpayers (Jan. 21, 2010), available at <http://www.whitehouse.gov/the-press-office/president-obama-calls-new-restrictions-size-and-scope-financial-institutions-rein-e>.

The following discussion highlights several examples of the orientation and limitations of the Plan. The examples are the proposed expanded role of the Federal Reserve as systemic risk regulator, risk management and related capital regulation reform, and the proposal to establish a consumer financial protection agency. This Part explains how each of these proposals, even one potentially beneficial to consumers of financial products, reinforces the dominance of finance and financial conglomerates. It also refers to the emerging fissures in the Administration's favorable view of financial conglomerates.

A. The Expanded Role of the Federal Reserve

A central part of the Plan would enhance the role of the Federal Reserve. Under current law, the Federal Reserve is the supervisor of the financial conglomerates, which in technical terms means that it is the designated regulator of bank and financial holding companies.³¹ Before the crisis, these included all the commercial banking conglomerates, such as Citigroup and Bank of America.³² However, the Federal Reserve's supervisory role over the bank or financial holding company is limited by what is called "functional regulation."³³ That is, although the Federal Reserve is the regulator of the holding company, its supervisory role over the holding company's subsidiaries is limited: the Federal Reserve is the primary regulator of a subsidiary only if that subsidiary does not have a "functional regulator."³⁴ For example, a commercial bank owned by a financial holding company would be regulated by the Office of the Comptroller of the Currency ("OCC") or a state bank regulator, depending upon whether it is chartered as a national or state bank; an investment bank subsidiary would be regulated as a broker-dealer by the Securities and Exchange Commission ("SEC"); any insurance subsidiary would be regulated by a state insurance regulator. In this scheme of regulation, the Federal Reserve must defer to a functional regulator with respect to regulation of many of the most important parts of a financial conglomerate.³⁵

31. See 12 U.S.C. § 1844(a) (2009). Since all the financial conglomerates have elected financial holding company status, my discussion focuses on the financial holding company regulatory status, not the bank holding company option.

32. For a list of financial holding companies, see *The Federal Reserve Board: Financial Holding Companies*, <http://www.federalreserve.gov/generalinfo/fhc/> (last visited Feb. 25, 2010).

33. See 12 U.S.C. § 1844(c) (2009).

34. See 12 U.S.C. § 1844(c)(5).

35. Essentially, under § 1844 the Federal Reserve must defer to the functional regulator's overall regulation of the functionally-regulated subsidiary, to its examination of that subsidiary, to reports made by the subsidiary to the functional regulator, and to capital

The Plan would make the Federal Reserve a “super-regulator” for an expanded number of financial conglomerates, which would include both certain financial holding companies and also conglomerates currently outside its jurisdiction. In some cases, the Plan extends the Federal Reserve’s authority to include otherwise unregulated entities, such as hedge fund advisors, private equity firms, any of their funds, insurance groups, or any financial group the failure of which would pose a systemic risk to the financial system.³⁶ Together, these conglomerates and other entities would be known as “Tier 1” financial holding companies.³⁷ Under the Plan, the Federal Reserve would have direct supervision over these firms and their parts, with its supervisory power no longer circumscribed by the authority of functional regulators like the SEC.³⁸ The legislation implementing this part of the Plan, which is working its way through Congress, establishes this primacy of the Federal Reserve in the regulation of these Tier 1 institutions, even though it has the Federal Reserve working cooperatively with other financial regulators.³⁹

The basic justification for expanding the Federal Reserve’s power is that the demise of any of the financial conglomerates, as seen in the financial crisis, threatens the financial system, i.e., it creates “systemic risk.”⁴⁰ Having numerous, independent regulators for the various parts of a financial conglomerate means that no one of them is responsible for the overall financial position and stability of the conglomerate itself and for its effects on the financial system as a whole. Moreover, without a “regulator in chief,” exposures, activities, and risks within the conglomerate could escape regulation and oversight altogether. The Plan would remedy this regulatory failure by giving the Federal Reserve this regulatory task, although, as discussed below, the Federal Reserve would be helped in its

standards for such subsidiary set by the functional regulator. *See* 12 U.S.C. § 1844 (2009).

36. *See* A NEW FOUNDATION, *supra* note 2, at 10–11, 21–24. Under current law, the Federal Reserve has jurisdiction over bank and financial holding companies only if a federally insured bank is a subsidiary of the holding company. *See* 12 U.S.C. § 1841 (2009).

37. *See* A NEW FOUNDATION, *supra* note 2, at 22–24.

38. *See id.* at 19–22, 25–26.

39. *See, e.g.*, H. COMM. ON FIN. SERV., FINANCIAL STABILITY IMPROVEMENT ACT § 1104 (discussion draft, Oct. 27, 2009) [hereinafter Discussion Draft]. Again, since the time of writing and revising this essay, new legislation has been introduced with respect to financial reform. *See, e.g.*, Senate Committee on Banking, Housing and Urban Affairs, Summary: Restoring American Financial Stability (summarizing new Senate bill). This proposed legislation will not be discussed in this essay.

40. *See* A NEW FOUNDATION, *supra* note 2, at 21–22.

efforts with respect to risk oversight by a council of the chief financial regulators.⁴¹

There are several ways in which enhancing the role of the Federal Reserve supports and extends the dominance of financial conglomerates in the United States. First and obviously, this part of the Plan accepts the existence of the conglomerates as an unchangeable reality and implicitly rejects a logical alternative, which is to break them up. In other words, the Plan asserts that the status of the conglomerates cannot be questioned, and therefore that the only justifiable policy is to stabilize them and to deal with the risks that they pose to the financial system. Giving these institutions a special regulator reinforces the financial conglomerate as the norm. Moreover, expanding beyond financial holding companies the kinds of financial groups that would be Tier 1 holding companies only supports this perspective, since they, like the regulated conglomerates, are involved in complex and diverse financial activities. In sum, the status of the financial conglomerates is never questioned, even though the destruction caused by financial conglomerates has resulted in losses not only to shareholders but to many in the United States who have suffered from the recession and now bear the increased tax burden of the rescue programs.⁴²

In addition, giving the Federal Reserve this expanded regulatory role promotes financial conglomerates and thus “big” finance because, historically, the Federal Reserve has been the regulator that championed the creation of the conglomerate. The complete story of the erosion and demise of the former legal structure in which financial services had to be kept apart is beyond the scope of this Article. A significant chapter in the story is the Federal Reserve’s support for ending the separation between commercial and investment banking, as well as between insurance and banking, and aggressively encouraging the formation of the U.S. financial conglomerate.⁴³ Moreover, as has been abundantly clear throughout

41. Another part of the Plan (to be discussed in passing later) would give the Treasury, aided by the Federal Reserve and other banking authorities the related power to take over and “resolve” a failing large financial group. *See id.* at 76–78.

It must be emphasized that, in proposing the concept of a systemic risk regulator and primary supervisor of financial groups, the Administration drew support from scholars of financial regulation. *See, e.g.,* Saunders et al., *supra* note 15, at 139.

42. It is odd that financial conglomerates have been treated much more gently than the industrial conglomerates that were takeover targets in the 1980s because the latter were seen to be destructive of shareholder value. For a critical summary of this perspective, see MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 94–115 (1995).

43. *See, e.g.,* LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES: CASES AND MATERIALS 53–55 (3d ed. 2008). For a pano-

the financial crisis, the Federal Reserve is inclined to protect large financial groups—even those that were previously outside its regulatory ambit, such as the large investment banks. The Federal Reserve has protected these groups even where this protection meant that it had to pick the survivors among the groups. It allowed Goldman Sachs and Morgan Stanley to become financial holding companies on an emergency basis in order to preserve their very existence;⁴⁴ it helped engineer the sales of Merrill Lynch to Bank of America (a transaction that remains subject to litigation)⁴⁵ and Bear Stearns to JP Morgan Chase;⁴⁶ and it contributed to the efforts to keep insurance conglomerate American International Group afloat.⁴⁷ Most of the programs in which the Federal Reserve participated during the financial crisis, such as those for reestablishing the market for asset-backed securities and removing toxic loans and securities from the books of financial firms, have been primarily designed to improve the financial position of the financial conglomerates.⁴⁸

ramic view of the regulatory and industry changes that produced the financial conglomerate, and their dangers, see Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215 (2002).

44. See, e.g., Jon Hilsenrath et al., *Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis*, WALL ST. J., Sept. 22, 2008, at A1.

45. See SEC v. Bank of America, 653 F. Supp. 2d 507, 509, 512 (S.D.N.Y. 2009) (a district court refused to accept a \$33 million dollar settlement between the SEC and Bank of America on the issue of disclosure violations regarding the bonuses because the settlement was “neither fair, nor reasonable, nor adequate”); see also SEC v. Bank of America, 2010 WL 624581 (S.D.N.Y. Feb. 22, 2010) (the same district court accepted a revised settlement).

46. In particular, the Federal Reserve made a \$29 billion loan as part of J.P. Morgan’s purchase of Bear Stearns, with the loan being “non recourse” as to J.P. Morgan and only collateralized by \$30 billion of Bear Stearns assets placed in a separate vehicle (with J.P. Morgan agreeing to take the first \$1 billion loss on the collateral). See *Turmoil in U.S. Credit Markets: Examining the Recent Actions of Federal Financial Regulators Before the S. Comm. on Banking, Hous. and Urban Affairs*, 110th Cong. (2008) (testimony of Jamie Dimon, CEO, JP Morgan Chase). See generally Stephen G. Cecchetti, *Crisis and Responses: The Federal Reserve and the Financial Crisis of 2007–2008* (Nat’l Bureau of Econ. Research Working Paper No. 14, 134, 2008), available at <http://www.nber.org/papers/w14134>.

47. See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-09-975, TROUBLED ASSET RELIEF PROGRAM: STATUS OF GOVERNMENT ASSISTANCE PROVIDED TO AIG 28–30 (2009) (summarizing the Federal Reserve’s assistance to AIG).

48. One program, the Term Asset-Backed Securities Loan Facility or “TALF,” is designed to restart loan securitization outside the home mortgage context, an activity engaged in by the conglomerates. For complete information on this program, see BD. OF GOVERNORS OF THE FED. RESERVE, TERM ASSET-BACKED SECURITIES LOAN FACILITIES, (2009), <http://www.federalreserve.gov/monetarypolicy/talf.htm> (last visited Mar. 18, 2010). Another is the public-private investment partnership, which is designed to fund

The Federal Reserve has consistently given the following public interest defense for its actions with respect to the financial conglomerates: if one of them fails, the financial system and the economy may collapse, which will be destructive for everyone. It never explains why the financial system and the economy are dependent on this current configuration of financial institutions, other than the unspoken justification that this *is* the outcome that the “market” has given us.⁴⁹ That the Administration’s point man for the Plan, Timothy Geithner, is an important Federal Reserve alumnus (former president of the Federal Reserve Bank of New York,) underscores how the Plan’s support of the current state of finance is overdetermined.⁵⁰

The Plan proposes that the Federal Reserve will enhance its oversight of Tier 1 financial groups or institutions using accepted methods of regulating financial firms—improved capital, liquidity, and risk management standards.⁵¹ Capital requirements, the chief form of regulation, are based upon agency theory (again, the paradigmatic theoretical framework in finance) insofar as they require owners of a financial institution to have their own assets invested in the venture. This is thought to ensure that out of self-interest the owners will prevent their institution from participating in excessively risky investments and activities, for the owners would suffer the initial losses. Capital requirements in financial institutions are “risk-based,” which simply means that the amount of capital required is determined by the risk of the institution’s investments and activities, as either measured by the risk models of the firm or in accordance with a risk determination pre-set by regulators.⁵² Yet risk models can be flawed and capital can turn out to be insufficient, as was seen during the crisis

private investors so that they can remove toxic assets from financial institutions’ books (again, the financial conglomerates are holders of many of these assets). For a description of this program, see *U.S. Dep’t of Treasury—Road to Stability: Public-Private Investment Program*, <http://www.financialstability.gov/roadtostability/publicprivatefund.html> (last visited May 23, 2010). Under the first program, which now can reach troubled assets as well as securities backed by new loans, the Federal Reserve provides low-interest loans to the private investors. For a critical discussion, see Office of the Special Inspector Gen. for the Troubled Asset Relief Program, *Quarterly Rep. to Cong.* 72–76 (2009).

49. See, e.g., *Regulatory Reform Before the H.R. Comm. on Financial Serv.*, 111th Cong. (2009) [hereinafter *Regulatory Reform Hearing*] (testimony of Daniel K. Tarullo, Member of the Board of Governors of the Fed. Reserve Sys.).

50. *Biography of Timothy F. Geithner, Secretary of the Treasury*, U.S. DEP’T OF TREASURY, <http://www.ustreas.gov/organization/bios/geithner-e.shtml> (last visited Mar. 26, 2010).

51. See A NEW FOUNDATION, *supra* note 2, at 24–25.

52. The subject of capital determination in financial firms is beyond the scope of this Article. See generally PETER S. ROSE & SYLVIA C. HUDGINS, *BANK MANAGEMENT & FINANCIAL SERVICES* 475–98 (7th ed. 2008).

when numerous financial institutions proved to be inadequately capitalized in face of the losses triggered by the subprime loan meltdown.⁵³ Thus, enhanced capital regulation by the Federal Reserve is hardly comforting as a way to deal with the risks posed by the Tier 1 institutions, particularly since the Federal Reserve oversaw the capital positions of financial holding companies, like Bank of America and Citigroup, that nearly failed in the crisis.⁵⁴ Moreover, one wonders how heightening capital requirements on financial conglomerates can ameliorate agency conflicts at all if, as is now clear, the federal government will not allow a Tier 1 institution to fail. The owners assume that their firm will never be allowed to fail, and their equity position will not be wiped out, thus making the risk-exposure function of capital requirements almost meaningless.⁵⁵

Requiring a financial conglomerate to have adequate sources of liquidity is a response to the phenomenon that occurred during the crisis: firms collapsed or nearly did because they relied excessively on short-term financing, which vanished in the crisis. International financial standard setters are now cautioning financial firms to be prepared for this “liquidity risk” by having funding that can see them through several years of hard times.⁵⁶ This means that a firm has to alter its debt financing structure to make most of its funding long term. However, it is questionable whether any financial conglomerate can have enough liquidity to withstand a systemic crisis, which occurs because of its and other firms’ risky investments and because of their opaque relationships with each other. It must be remembered that even the “best” of the financial conglomerates, including Golden Sachs (which has occasionally asserted

53. See James Fanto, *Anticipating the Unthinkable: The Adequacy of Risk Management in Finance and Environmental Studies*, 44 WAKE FOREST L. REV. 731, 741–42 (2009) [hereinafter Fanto, *Anticipating the Unthinkable*].

54. The Federal Reserve claims that its supervision has always focused on the financial institutions that pose the greatest risk to the financial system. See FED. RESERVE BD., SUPERVISORY LETTER SR 08-9/CA 08-12, CONSOLIDATED SUPERVISION OF BANK HOLDING COMPANIES AND THE COMBINED U.S. OPERATIONS OF FOREIGN BANKING ORGANIZATIONS (2008), available at <http://www.federalreserve.gov/boarddocs/srletters/2008/sr0809.htm>.

55. As discussed below, the Plan does call for a plan for winding up financial conglomerates, but one has to wonder if this is legislative window dressing.

56. See, e.g., BANK FOR INT’L SETTLEMENTS, BASEL COMM. ON BANKING SUPERVISION, PRINCIPLES FOR SOUND LIQUIDITY RISK MANAGEMENT AND SUPERVISION 3 (2008).

that it never needed a government rescue),⁵⁷ would have collapsed in October 2008 without all of the government protections given to them.⁵⁸

The above discussion returns repeatedly to the concept of risk, which is the province of risk management and deserves a section of its own. However, as noted earlier, it is important to point out that the monolith mindset about the status quo of financial conglomerates is beginning to exhibit fissures. One example of the growing skepticism about the conglomerates is appearing in recent reflections on capital regulation for them. For example, Federal Reserve Governor Tarullo mentioned as a possibility a new “special capital requirement,” which would be in addition to capital requirements determined on a risk basis, to be imposed on the Tier 1 institutions.⁵⁹ Such a charge, he implies, would in essence penalize large firms and discourage institutions, through this cost, from becoming conglomerates.⁶⁰ Even Treasury Secretary Geithner discussed the possibility of limiting firm size when providing his views on a discussion draft of the proposed legislation enhancing the Federal Reserve’s powers. He made the following somewhat startling statement: “Regulators must be empowered with explicit authority to force major financial firms to reduce their size or restrict the scope of their activities when necessary to limit risk to the system. This is an important tool to deal with the risks posed by the largest, most interconnected financial firms.”⁶¹

57. See Joe Nocera, *Short Memories at Goldman*, N.Y. TIMES, Oct. 23, 2009, at B1.

58. Beyond the government’s capital infusion, these included the ban on short selling of the stock of financial institutions, access to discounted Federal Reserve loans, guarantees of debt issued by financial conglomerates, and the rescue of AIG, which had financial conglomerates (like Goldman) as its counterparties. See Press Release, S.E.C., S.E.C. Halts Short Selling of Financial Stocks to Protect Investors and Markets (Sept. 18, 2008), available at <http://www.sec.gov/news/press/2008/2008-211.htm>; Press Release, Fed. Reserve, FOMC Statement (Oct. 29, 2008), available at <http://www.federalreserve.gov/newsevents/press/monetary/20081029a.htm>; Press Release, U.S. Dep’t of Treasury, Fed. Reserve, and Fed. Deposit Insurance Corp., (Oct. 14, 2008), available at <http://www.federalreserve.gov/newsevents/press/monetary/20081014a.htm>; Christine Seib, *AIG Rescued by U.S. Fed. Reserve with \$85bn bailout*, TIMES ONLINE, Sept. 17, 2008, http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article4771465.

59. See *Regulatory Reform Hearing*, *supra* note 49, at 4. Governor Tarullo described the charge as also being risk-based insofar as the charge would increase the more systemic risk an institution posed.

60. Governor Tarullo also referred to another possible reform related to capital: require financial conglomerates to have “contingent capital,” which means debt that, in certain circumstances, changes to equity. See *id.* at 4–5.

61. *Hearing Before the H. Comm. on . Fin. Serv. 4*, 111th Cong. (Oct. 29, 2009) [hereinafter Geithner Testimony] (Testimony of Timothy F. Geithner, Sec’y of the Treasury). Indeed, the Discussion Draft includes a provision allowing the Federal Reserve to

B. Risk Management, Centralization of Regulation, and Complexity

As noted above, the Plan promises that the Federal Reserve will enhance risk management in the Tier 1 conglomerates or institutions. Additionally, the Plan proposes that a Financial Services Oversight Council be organized, which will, among other things, replace the President's Working Group on financial markets. The Oversight Council will identify emerging risks in the financial industry.⁶²

A few words about risk management are in order here. The system commonly known as risk management in fact comprises both risk assessment and risk management. Risk assessment is designed to identify the risks a financial institution faces from its investments and activities. The firm's board and executives use the risk assessment to decide upon the appropriate risk profile for the firm and to ensure that the institution keeps within these boundaries and takes actions to minimize the losses associated with, and otherwise to address, these risks—this is risk management proper.⁶³ Risk management is critical for financial institutions because the adequacy of a financial institution's capital, which is the primary device for keeping the firm's activities in check, is determined in accordance with a risk assessment of these activities and assets.⁶⁴ Indeed, financial regulators permit financial conglomerates, such as those that would be designated Tier 1 under the Plan, to conduct this risk assessment using the conglomerates' own risk models and methods, rather than having to use the risk framework established by the regulators.⁶⁵ The Federal Reserve and other financial regulators now supervise this risk

force a financial conglomerate to reduce its size. *See* Discussion Draft, *supra* note 39, at 19.

62. *See* A NEW FOUNDATION, *supra* note 2, at 20–21. In the Discussion Draft, the Council is composed of the Secretary of the Treasury and the heads of the Federal Reserve, the OCC, the SEC, the FDIC, the CFTC, the Federal Housing Finance Agency, and the National Credit Union Administration, and has two nonvoting members (a state banking commissioner and a state insurance regulator). *See* Discussion Draft, *supra* note 39, at 5–7. Among other things, the Council would issue prudential regulations dealing with systemic risk that financial regulators would have to adopt and it would identify financial firms and financial practices to be subject to heightened financial regulation by the Federal Reserve. *See id.* at 8–11.

63. *See generally* Rose & Hudgins, *supra* note 52, at 30.

64. *See id.* at 483–84.

65. *See* Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II, 72 Fed. Reg. 69,288, 69294–98 (Dec. 7, 2007) (explaining how the internal model approach, which was used to measure market risk, is now extended to credit and operational risk).

assessment and all the risk management practices of the firms under their regulatory authority.⁶⁶

I have argued elsewhere that, for several reasons, risk management in the large financial groups and regulatory supervision of it failed greatly contributing to the financial crisis; indeed, this crisis is one of risk management.⁶⁷ Risk management models for predicting losses in assets and from activities were often programmed with incomplete or faulty data that downplayed potential losses; risk managers ignored established methods, such as stress testing and scenario analysis, to evaluate an institution's preparedness for extreme scenarios; results were ignored or not taken seriously by financial institution executives and board members; and financial regulators accepted without criticism the risk models and processes of institutions and did not insist that they be improved when problems were found. In addition, risk managers and financial regulators ignored certain risks, such as the liquidity risk and risk from compensation design that became apparent in the crisis.

Certainly, financial institutions and regulators now have "got religion" on risk management. Model shortcomings are being rectified; stress testing and scenario analysis are being undertaken (indeed, the 19 largest financial groups had to undergo a government-designed stress test);⁶⁸ executives and boards are meeting with risk managers, who have assumed new importance in their organizations; and regulators are examining the risk management practices of firms (this is what the government stress testing was designed to accomplish). Therefore, the Plan's proposal that the Federal Reserve and the Oversight Council monitor risk management in financial institutions more closely must be understood as part of ongoing risk management reform efforts.

Yet there are problems with the Plan's reform of risk management because its fundamental approach is misguided and because it underestimates the dangers arising from financial conglomerates. The solution of having an Oversight Council on the lookout for emerging risks is based upon an assumption that a group of regulators at the summit of the regu-

66. See DIV. OF BANKING SUPERVISION & REG., FED. RESERVE BD., BANK HOLDING COMPANY SUPERVISION MANUAL supp. 28 § 4070 (2005) (discussing the Bank Holding Company Rating System that includes a rating on an "R" component, which represents risk management).

67. See Fanto, *Anticipating the Unthinkable*, *supra* note 53, at 739–45.

68. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: DESIGN AND IMPLEMENTATION 2–4 (2009) (discussing the methodology of the stress test); BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: OVERVIEW OF RESULTS (2009) (discussing its results).

latory structure can rationally and panoramically survey financial institutions and financial practices, detect emerging risks therein, and then require firms to eliminate or lessen the destructive effects of these risks. This perspective is the same one that characterizes current risk management in Tier 1 financial institutions (and in most other financial institutions, for that matter), where a risk oversight committee (of directors, executives, or a combination of both), with the help of a firm's risk management department and its internal control department, assesses the risks of an enormous financial group and then manages them within risk parameters set down by the entire board. This perspective is thus "top down" and highly rationalist in nature.

The financial crisis showed that this approach to risk analysis and management, when it is used exclusively, is faulty. Almost without exception, financial firms and regulators failed to see the risks of the asset-backed securities that sparked the financial cataclysm. More importantly, they failed to anticipate the widespread illiquidity of assets and freezing up of transactions that followed the meltdown in the asset-backed securities market. They were unprepared for a phenomenon that is known as "tail dependence" in the risk literature.⁶⁹ This means that an extreme event in one domain (such as a failure in the market for securities backed by subprime loans) can lead, in unexpected ways, to equally extreme consequences in other domains, such as in all asset-backed securities and then in all loans and securities, which in turn aggravates the decline in the original domain.

Certainly, as mentioned above, risk management has improved in financial institutions, and regulators are taking it more seriously. However, the top down approach may prevent both firms and regulators from dealing with catastrophic risks, which matter the most and whose identification is the whole point of the reform. It is likely that these risks will be identified in two ways: (i) by risk managers who are working closely with specific financial activities and are attuned to developments in the market and (ii) by risk managers who play out counterfactual or counterintuitive scenarios with respect to their financial institutions and the financial system. It appears that an Oversight Council, like a firm's risk committee, is simply too removed from group (i) and must depend upon an extended chain of reporting, which may well attenuate any message about risk that it receives. It is also difficult to imagine that an Oversight Council (again like a firm's risk committee) will take the time to serious-

69. See BANK FOR INT'L SETTLEMENTS, BASEL COMM. ON BANKING SUPERVISION, PRINCIPLES FOR SOUND STRESS TESTING PRACTICES AND SUPERVISION 9–10 (2009).

ly consider imaginative scenarios, as opposed to standard risks with which its members are familiar.

Moreover, even if the Oversight Council established reliable access to the risk managers “on the ground” and had the initiative to run, and take seriously, an analysis of unlikely scenarios, it is still unclear whether the Council would be able to predict with any accuracy the catastrophic risks arising from financial conglomerates. The Tier 1 groups are involved in so many financial activities and are interconnected in such complex ways that it is difficult for any person, firm, regulator or council of regulators to see all the emerging risks in them and to predict the consequences of acute negative events. As the crisis has shown, the tail dependence phenomenon in this part of the financial sector and in the international financial system in which the conglomerates play such a great role is both particularly hard to predict and extremely destructive. In risk management, the financial conglomerates may be too complex to manage.

Furthermore, the Oversight Council’s “top down” perspective on risk management maintains and even valorizes the status quo of financial conglomerates in the financial system. The message of the Plan is that risk management in these institutions can best be supervised only by a government body that is as centralized and powerful in regulation as they are in finance.⁷⁰ From this perspective there is little acknowledgement of the possibility that, since catastrophic risks are difficult to identify and their consequences in the complex financial institutions are almost impossible to predict, the financial conglomerate might be too dangerous an institutional form of providing financial services.⁷¹

C. Consumer Financial Protection

A final example of the Plan’s financial reforms is the proposed creation of a Consumer Financial Protection Agency (“CFPA”), which, as its name suggests, would be charged with protecting consumers in their acquisition of financial products, such as credit, savings, payment, and other consumer financial products and services.⁷² This federal agency would

70. In reality, the Council is a political accommodation by the Obama Administration, which initially wanted to place the major power with respect to financial conglomerates with the Federal Reserve and to give the Council only an advisory role. The Discussion Draft increases the importance of the Council. Yet my point about the reform as valorizing financial conglomerates holds, whether the Federal Reserve or the Oversight Council is in charge.

71. Again, as discussed earlier, there are signs that this alternative perspective on the financial conglomerates is beginning to be acknowledged, even in the Discussion Draft. See Discussion Draft, *supra* note 39.

72. See A NEW FOUNDATION, *supra* note 2, at 55–63.

have the sole rule-making authority under existing consumer protection financial laws and have supervisory, examination, and enforcement authority over financial institutions (even unregulated ones) in this domain. It would set a floor for consumer protection for the states, which could still impose higher standards, and it would cooperate with them in consumer protection and enforcement efforts. Among other things, the CFPA would be directed to improve the financial industry's disclosure on consumer financial products, to require that there be "plain vanilla" products in each financial area,⁷³ to restrict unfair, abusive, or deceptive terms in consumer financial contracts (and, if necessary, to ban mandatory arbitration in consumer financial contracts), and to impose fiduciary duties upon financial services providers.⁷⁴

The CFPA is inspired by the work of Professor Elizabeth Warren of Harvard Law School, one of the foremost consumer finance scholars and currently a member of the Congressional Oversight Panel of the Treasury's Troubled Asset Relief Program.⁷⁵ It is intended to replicate at the federal level the consumer protection and paternalistic orientation of the states. Under federal financial law, consumer protection is generally limited to disclosure: for example, consumers must receive considerable disclosure about loan terms or savings or other account terms from banks, and banks are penalized if this disclosure is inadequate.⁷⁶ The CFPA's approach would be different and more along the lines of product safety regulation. The agency would evaluate a financial product, such as a loan, on its merits in order to determine whether it is beneficial to consumers and whether its potential harms outweigh its benefits.⁷⁷ If the regulator were to determine that the product or features of it were too toxic, it would not allow financial institutions to sell the product to consumers, or it would require them to eliminate the product's toxic features.⁷⁸ This approach echoes the traditional focus of state securities and

73. *See id.* at 70–71.

74. Under the Plan, the SEC's consumer protection authority in investment products would also be enhanced, primarily with respect to disclosure before sale. *See id.* at 71–72.

75. *See, e.g.*, Elizabeth Warren, *Unsafe at Any Rate*, DEMOCRACY: A J. OF IDEAS, (Summer 2007) (detailing the reasons we need a consumer financial safety commission).

76. This simplifies a complex area of the law. *See, e.g.*, Truth in Lending Act, 15 U.S.C. §§ 1601–93 (2006); Truth in Savings Act, 12 U.S.C. §§ 4301–13 (2006). Similarly, SEC regulation of financial products is essentially disclosure-based: under this theory investors should receive material information about an investment, no matter how speculative it is, but should not be prohibited from investing in it.

77. *See* A NEW FOUNDATION, *supra* note 2, at 55–58.

78. One thinks in this regards of certain home mortgages that were made to borrowers on the basis of no investment and no documented income, and that had higher interest rates that would kick in after an initial teaser rate. Such loans were almost certain to harm

banking departments that evaluate the merits of investments and loan products offered to their citizens.⁷⁹

It may seem inappropriate to lump the CFPA with the centralization of regulatory power in the Federal Reserve and the flawed approach to risk management as an additional example of problems in the Plan. Certainly, the focus on the consumer is a welcome political recognition that financial regulators failed in their consumer protection mission and were devoted almost solely to the well-being of the financial firms over which they have supervisory responsibility. The CFPA provides consumers with a regulator whose mandate is only to protect their interests, rather than those of certain members of the financial industry. Under the Plan the CFPA would be a regulatory counterpart to the Federal Reserve, for it would be the “super-regulator” of consumer interests in finance just as the Federal Reserve would be for financial firms and the system. One obvious criticism (which I have expressed elsewhere)⁸⁰ is that, even though financial regulators would continue their consumer protection activities under the direction and guidance of the CFPA, that role may atrophy. The establishment of the CFPA “liberates” financial regulators by reinforcing their belief that their primary focus should be on their part of the financial industry.⁸¹

the consumer, except in the limited circumstances of a continued rise in real estate values. *See, e.g.*, U.S. Gov’t Accountability Office, GAO-09-848R, *Characteristics and Performance of Nonprime Mortgages*, (2009).

79. *See* Broome & Markham, *supra* note 43, at 419–33 (discussing Georgia’s efforts to regulate subprime loans).

80. *See* James Fanto, *The Rationale and Cautionary Remarks on the Proposed Federal Consumer Financial Product Regulator*, 2009 EMERGING ISSUES 3652 (2009).

81. This may be no great loss, given the existing orientation of the regulators and the fact that this Administration is more consumer-oriented than the last Administration. However, the country’s political orientation will inevitably shift over time. If a future Administration were less devoted to consumer financial protection, it could weaken the power of the CFPA by senior level appointments. By then, no financial regulator could step up to fill the consumer protection role.

It should also be noted that the enactment of legislation authorizing the CFPA is by no means certain. There were initially two bills in the House with differences in the structure and mandate of the CFPA. *See* Jewel Edwards, *Energy and Commerce Passes CFPA Bill, Splits with Financial Services Panel’s Version*, 93 BANKR. L. REP. (BNA) 841 (2009). The version from the House Financial Services Committee was H.R. 3126. As such, it is different in important respects from the version originally introduced on behalf of the Administration. For example, H.R. 3126 does not allow the CFPA to require financial institutions to offer consumers “plain vanilla” financial products and the bill excludes certain parties (e.g., automobile dealers who offer credit to consumers) from coverage. *Consumer Financial Protection Agency Act, H.R. 3126*, 111th Cong. (2009).

Yet the centralization of consumer protection in the CFPA raises a criticism that is related to the earlier discussion of risk management. Many consumer financial and investment abuses, just as many risks to financial firms, can be detected best by people who are “close to the action” of the firm. In the case of consumer abuses, this means by regulators who deal directly with consumers. That is why state regulators, rather than federal financial regulators, have generally identified financial abuses of consumers first. The CFPA proposal thus suffers from the same “top down” perspective as does the proposal for expanding the Federal Reserve’s systemic risk authority. That is, it reflects the belief that a centralizing authority with panoramic vision is best at dealing with consumer financial abuses. It is true that the Plan does not threaten or undercut state power in consumer protection. It explicitly discourages preemption, permits states to offer greater consumer protection than what would be provided under federal law, encourages state and federal cooperation in consumer protection, and even allows states to enforce provisions of new consumer financial protection laws that would be enacted with the establishment of the CFPA.⁸² That approach to consumer protection would be “bottom up,” which would be much more valuable in detecting and addressing consumer abuses.⁸³

Finally, in a perverse way the CFPA reaffirms the importance of the financial conglomerates, just as do other aspects of the Plan. Advocates for the CFPA clearly believe that consumers need such an agency to protect them from the conglomerates, which have their protectors in the current federal financial regulators and in a strengthened Federal Reserve. The assumption behind the CFPA is that the Tier 1 institutions are the status quo and here to stay, and therefore the only recourse for consumers is to seek protection in a powerful, consumer-oriented federal agency. Another option, such as keeping financial institutions smaller (as discussed below), would obviate the need for a supercharged federal consumer regulator.⁸⁴

82. See A NEW FOUNDATION, *supra* note 2, at 60–61. H.R. 3126 preserves this initial thrust of the Plan. See Subtitle D—Preservation of State Law, H.R. 3126, at §§ 141–50.

83. A concern remains that a centralized, powerful federal regulator would gradually assert more and more authority and could eventually encroach upon the jurisdiction of state regulators. Then, if political winds change and the CFPA becomes less assertive as to consumer protection, state financial regulators might not be ready and capable of dealing with consumer abuses.

84. Legislation might still be needed, as in H.R. 3126, to reaffirm the importance of state consumer protection and to protect it against preemption efforts by federal financial regulators.

III. AN ALTERNATIVE PERSPECTIVE

It is fair to ask whether the Obama Administration will propose any transformational reform of financial institutions if there is no further meltdown in the financial markets. Many financial conglomerates that survived the financial collapse with the extraordinary help of the Treasury, the Federal Reserve, and other federal financial regulators are boasting about their profits (generally made from proprietary trading on the basis of cheap funds available from the Federal Reserve and leverage), have paid back their TARP funds,⁸⁵ and are reasserting themselves by offering a revisionist history of the meltdown (“we never needed government support”).⁸⁶ They are now trying to remove the teeth from proposed regulation.⁸⁷ The crisis has in fact made the financial sector even more concentrated with the new class of Tier 1 institutions that would receive the government’s designation as “systemically important,” are implicitly regarded as “too big to fail,” and can thus raise funds at a discount.⁸⁸ Financial regulators and those in the current Administration responsible for financial policy come from or have close ties to financial conglomerates and are steeped in the ideology of finance.⁸⁹ Thus, as explained in the previous part, the reforms proposed in the Plan reflect this ideology and reinforce the position of the financial conglomerates.⁹⁰

I offer below one thought for reform that comes from a perspective that is critical of the current dominance of financial conglomerates and that is skeptical of the virtues of finance in the United States. The primary goal of this reform would be to break up the financial conglomerates on the ground that, because of their complexity and rent-seeking, they pose too many risks to the financial system, the economy and political well-being of this country. This proposal would benefit the market for financial ser-

85. See, e.g., *Morgan Stanley Buys TARP Warrants from Treasury for \$950 Million*, 21 BANK. REP. (BNA) 1160 (2009).

86. See Joe Nocera, *Short Memories at Goldman*, N.Y. TIMES, Oct. 23, 2009, at B1 (discussing revisionist history of financial crisis espoused by Goldman). *But see* Letter from Lloyd C. Blankfein, Chairman & CEO, Goldman Sachs Group, to Barney Frank, Chairman, and Spencer Bachus, Ranking Member, H. Fin. Serv. Comm. (June 16, 2009) (expressing Goldman’s appreciation for government support).

87. See Joe Nocera, *Have Banks No Shame?*, N.Y. TIMES, Oct. 9, 2009, at B1 (discussing bank resistance to reform).

88. See David A. Moss, *An Ounce of Prevention*, HARV. MAG., Sept.–Oct. 2009, AT 25, 27.

89. See, e.g., Jackie Calmes, *Obama Aide Declines Visit to Bank Board*, N.Y. TIMES, July 20, 2009, at B1 (discussing ties between Obama’s Chief of Staff and close friend, Rahm Emmanuel, and financiers, particularly the CEO of JP Morgan Chase).

90. As noted above, however, there are those in the Administration who are beginning to look more critically at the conglomerates.

VICES because the break-up of these institutions would allow for the growth and development of smaller, more specialized financial institutions. As will be explained below, this reform goal does accept the necessity of one of the proposals in the Plan, which is to empower a federal regulator to wind up the Tier 1 institutions. Following the discussion of this goal, this Part briefly emphasizes key disadvantages of the Plan's alternative reform approach of allowing the conglomerates to continue to exist as such while regulating them more.

A. The End of the Financial Conglomerate

The goal of reform should be to break up the financial conglomerates, given the unacceptable economic and social destruction that they cause, unless—what is unlikely—they can survive without government subsidies. The reform would have to include legislation that would undo, wholly or partially, the creation of the financial holding company that ratified the existence of the financial conglomerate. The legislation would separate the parts of a conglomerate with a deposit-taking function⁹¹ from many of the investment banking, insurance, financial instrument trading, and proprietary trading activities that have proven to add to the complexity and thus to pose the most danger to the conglomerates.⁹² It would give bank holding company status, and the benefits of Federal Reserve support that comes with it, only to institutions with this traditional banking focus. This legislation would thus return banking regulation to the pre-Gramm-Leach-Bliley situation of separate, often limited purpose financial institutions and would require financial regulators again to engage in line-drawing about the permissible functions of the regulated firms.⁹³ These restrictions and regulatory assertiveness, rather

91. Conglomerate parts with deposit-taking functions include banks or savings and loans, or the equivalent of consumer deposits in money market funds, and the government insurance that goes with them.

92. Naturally, this legislation would be complicated, for it would have to decide which financial activities (e.g., selling asset-backed securities) would be permissible to the new, restricted bank holding companies.

93. This proposal echoes those made by others (particularly Simon Johnson) who argue for a separation between “simpler” financial firms receiving government support and another financial sector that would not have this support, but would be regulated. *See, e.g.*, Mervyn King, Governor of the Bank of England, Address to Scottish business organizations at Edinborough, Scotland (Oct. 20, 2009), available at www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf; ALEXANDER G. HALDANE & PIERGIORGIO ALESSANDRI, BANKING ON THE STATE (Sept. 25, 2009), available at <http://www.bankofengland.co.uk/publications/speeches/2009/speech409.pdf>; Moss, *supra* note 88; Ingo Walter, *The New Case for Functional Separation in Wholesale Financial Services*, 30–31 (N.Y.U. Stern School Bus., Working Paper, 2009), available at

than market freedom in financial services as exemplified by risk-based capital regulation, are the price that must be paid for financial and economic stability.

Pending legislative change, financial regulators have the authority to impose onerous regulations upon financial conglomerates so that they will be forced to pay for the numerous kinds of support that they receive and for the risks that they create, and so that they will find themselves more restricted in their activities.⁹⁴ The purpose of this changed regulatory approach is to push the conglomerates to transform themselves. On the basis of their federal subsidies and the risks that the conglomerates pose to the financial system, the Federal Deposit Insurance Corporation (“FDIC”) would also impose a high deposit insurance premium on the institutions that receive FDIC insurance.⁹⁵ For similar reasons, the Treasury and federal financial regulators would impose higher fees for the conglomerates’ participation in the support programs for financial institutions, which include the guarantee on debt issued by the firms, and their participation in such programs as the Term-Asset Backed Loan Facility and the Public-Private Investment Partnership (which removes troubled loans and securities from the banks’ books).⁹⁶ Additionally, if financial regulators accept that it is difficult, if not impossible, to set adequate risk-based capital requirements “scientifically” for these conglomerates, given their complexity and the accompanying uncertainty about “tail risks,” regulators could impose a special capital charge on the conglomerates as a safeguard.⁹⁷ In other words, the financial conglome-

<http://ssrn.com/abstract=1442148>. *But see* CARMINE DI NOIA ET AL., KEEP IT SIMPLE: POLICY RESPONSES TO THE FINANCIAL CRISIS 75 (2009); Lawrence White, *Lesson From the Debacle of '07-'08 for Financial Regulation and Its Overhaul*, 21–22 (N.Y.U. Stern School Bus., Working Paper, 2008).

94. *See* 12 U.S.C. § 1844(e).

95. *See* 12 U.S.C. § 1817(b) (2010). The FDIC has relative freedom here since the assessments are risk-based, but it would have to deal with a statute that requires it not to discriminate among banks on the basis of their size. *See* 12 U.S.C. § 1817(b)(2)(D) (2010).

96. Many of the initiatives are discussed on the Dep’t of Treasury’s website. *See* U.S. DEP’T. OF THE TREASURY, FINANCIAL SECURITY FACT SHEET 1, <http://www.financialstability.gov/docs/fact-sheet.pdf>. *See also* James Fanto, *The Treasury’s Efforts to Jumpstart Small Business Lending and TALF*, 2009 EMERGING ISSUES 3399 (2009). For a discussion of the FDIC’s guarantee program of senior unsecured debt, *see* FDIC: *Temporary Liquidity Guarantee Program Frequently Asked Questions*, <http://www.fdic.gov/regulations/resources/TLGP/faq.html> (last visited Mar. 18, 2010). Again, it would be difficult to justify legally a complete restriction on the conglomerates’ participation in these programs.

97. This could be done through the imposition of a higher basic capital ratio, often known as a leverage ratio, that is set based on an institution’s assets, without any adjust-

rates would not be able to control the capital determination process through their own risk-based models. With the imposition of these measures, among others,⁹⁸ rather than being at the receiving end of numerous kinds of government support, the financial conglomerates would have to make significant payments for the privilege of their existence. This might well cause them to shrink in size.⁹⁹

The government's gradual withdrawal of support from the conglomerates and the imposition of more exacting regulations and capital charges upon them would likely result in a gradual break-up of the firms. In a worst case scenario, it would lead to a sell-off of the shares and debt of these institutions, when the market perceives that the conglomerates now have to pay for the government guarantee that they receive, and perhaps a collapse of the weakest among them.¹⁰⁰ As was seen in the financial crisis, there will likely be serious disruptions to the financial system, if one or more of the financial conglomerates fail without an orderly resolution process. This would suggest that the part of the Plan that is designed to give the Treasury, with the assistance of the Federal Reserve, the FDIC, and the SEC, the power to take over and wind up financial conglomerates that pose systemic risk should take precedence in financial reform.¹⁰¹ Again, from this Article's perspective, a special resolution regime for the conglomerates would only highlight their importance in the financial system. However, if, in effect, government regulation con-

ment for risk. *See, e.g.*, 12 C.F.R. § 3.6(b) (2009) (leverage ratio for national banks). On a special leverage ratio proposal, *see, e.g.*, FINANCIAL STABILITY BOARD, OVERVIEW OF PROGRESS IN IMPLEMENTING THE LONDON SUMMIT RECOMMENDATIONS FOR STRENGTHENING FINANCIAL STABILITY 5–6 (2009). Alternatively, a special capital charge for complexity and risk could be added to the capital amount determined through the risk-based capital process. *See* DI NOIA, *supra* note 93, at 58–60; OLIVER HART & LUIGI ZINGALES, A NEW CAPITAL REGULATION FOR LARGE FINANCIAL INSTITUTIONS 21–23 (Chicago Booth Working Paper No. 09-36, Sept. 2009).

98. Another measure would be to have financial conglomerates issue “contingent” debt, which could be transformed into equity in certain events (e.g., when a firm's regulatory capital fell below a certain threshold). For a critical article on this concept, *see* Gillian Tett, *The Sweet Fix of CoCos?*, FIN. TIMES, Nov. 13, 2009.

99. As noted earlier, even the Treasury Secretary has announced support for this capital approach that would have this effect. *See, e.g.*, *Geithner Testimony*, *supra* note 61, at 3–4. *See also* TREASURY DEPARTMENT, PRINCIPLES FOR REFORMING THE U.S. AND INTERNATIONAL REGULATORY CAPITAL REQUIREMENTS FOR BANKING FIRMS 10–11 (2009) (supporting both a special capital assessment on large firms and the increased leverage ratio concept).

100. On the other hand, the market may perceive that the financial conglomerates, like industrial conglomerates, obscure the value of their parts, which would make break-ups financially attractive.

101. *See* A NEW FOUNDATION, *supra* note 2, at 76–78.

tributed to the creation of the conglomerates in the first place, it should be responsible for dealing with the fallout from their demise.¹⁰²

As a result of these reforms, we shall return to a time of smaller, more focused financial institutions. But this is likely to be for the better. For, then, the financial sector will be what it is supposed to be: a provider of capital raising, risk management, and other financial services to businesses and to consumers, rather than being rent seeking and economically and politically destabilizing.¹⁰³ It will also not be allowed continuously to produce crises that have destructive effects on the economy.¹⁰⁴

B. A Second Best Approach

One could, of course, argue that the above reform should not be attempted because of the threat to systemic stability. Financial institutions (and the economy) have just emerged from a crisis and remain in a precarious situation. It would therefore be foolhardy to trigger a new upheaval and potentially a recurrence of systemic risk. Therefore, it could be contended that it makes sense to pursue reforms that are incremental and thus less drastic than a break-up of financial conglomerates. This approach to reform would include many of those ideas proposed by the Plan and the implementing legislation, as discussed above. The Obama Administration appears to be taking this approach and to accept the conglomerates as a reality in finance. More recently, as also explained above, the Administration is taking a harder line on the conglomerates and contemplating that at least some of them could eventually be reduced in size and even eliminated.¹⁰⁵ From a pragmatic perspective, it wants the dismantling to happen gradually and in an orderly way.

The main problem with this approach, as attractive as it may seem in its pragmatism and middle-of-the-road quality, is that it is unlikely to reduce the influence of and thus the dangers posed by the financial conglomerates to the financial system, the economy, and the polity. As financial institutions and the financial system have stabilized, the conglomerates argue that no significant reforms to financial institutions are needed, because the crisis was due to external (i.e., exogenous) factors. Accordingly, they show their cooperation by agreeing to technical re-

102. This is not the place to discuss the resolution provisions of the bills moving through Congress. See H.R. 3126, 111th Cong. §§ 171–72 (2009); Restoring American Financial Stability Act, 111th Cong. §§ 201–10 (S. Banking Comm. 2009).

103. On the rent seeking of finance, see, e.g., Augar, *supra* note 17, at 204–21.

104. On the crises generated by the financial system, see the classic account by Hyman Minsky. See HYMAN P. MINSKY, *STABILIZING AN UNSTABLE ECONOMY* 77–106 (1986, rereleased 2008).

105. See *supra* notes 32, 65–67 and accompanying text.

forms, which arguably respond to regulatory lacunae revealed by the financial crisis. These are, for example, the Plan's enhancements to the Federal Reserve's oversight, risk management improvements, and revisions to capital standards. These reforms can be "sold" to the public as the necessary technological solutions for complex activities. They can also be politically satisfying to financial regulators and even legislators, who can then present themselves as responding to the crisis without directly confronting the power of the financial conglomerates. Moreover, it is likely that, rather than cynically protecting financial conglomerates, regulators and legislators believe that this is the best and most principled approach to take, for they have been indoctrinated by the ideology of finance.

The basic problem with this approach is that it gives the financial conglomerates the time to take control of the reform process. For example, in general they will likely agree to refinements to capital requirements for liquidity and other issues arising from the crisis. Yet reforms to capital alone still allow conglomerates considerable operational freedom and do not eliminate the dangers posed by their size and complexity. Since capital will remain risk-based and will be calculated on the basis of the firms' own risk models, they will ultimately control the capital determination, however much it is reformed (unless a high non-risk-based leverage ratio is imposed). Moreover, the ever increasing complexity of the products and activities engaged in by financial conglomerates plays into their hands when they are modeling their risk and determining their capital, since regulators cannot offer any credible alternatives to these models to evaluate the risks of a conglomerate's activities and investments. In sum, the catastrophic risks arising from the size of the firms and the complexities of their interconnected activities would not be addressed by this gradualist approach to reform. This result would argue for the alternative reform discussed in the preceding sub-Part, which is to break up the conglomerates as the only way to address their power and to eliminate the dangers posed by them.

CONCLUSION

In this Article, I have argued that the Plan maintains, and emphasizes the importance of, financial conglomerates engaged in a broad array of financial activities and would extend regulation to similar, but now unregulated, financial institutions like hedge fund groups, private equity firms, and insurance groups. The Article explained that the Plan is animated by an ideology of finance, which the major political parties and financial regulators have come to accept over the past three decades despite the economic and social destruction that finance has caused to the

country. It discussed how several features of the Plan—its enhancement of the Federal Reserve’s power, its proposed improvements to risk management and even the establishment of the CFPB—all reinforce the current dominance of financial conglomerates in our financial system. The Article then outlined an alternative reform approach that would have as its goal the breakup of these conglomerates, an approach that would demand legislation in the long term, but that could be undertaken now by financial regulators. The Article also argued that this reform would produce smaller, but less troubling, financial institutions. It finally contended that an alternative to this kind of reform, which would impose restrictions upon the conglomerates and eliminate the weaker of them—an approach now being espoused by the Obama Administration—would not eliminate the dangers that they pose, because the conglomerates would likely control regulations emerging from the reform, based as the regulations are on the conglomerates’ own risk models.

Several assumptions animate this Article. The first is that the financial conglomerates destabilize the financial system and the economy because they are involved in so many financial activities and have such interconnections with other firms that it is impossible for them to manage their risks effectively and thus to prevent dramatic spillovers and externalities into that system and the economy. A second, which has been alluded to but not explored at length, is that the conglomerates are also politically troubling because many of their activities have little to do with financing businesses and consumers, but with producing rents for themselves, and that they have thus contributed to significant economic disparities in the country, which are ultimately not conducive to a stable political system. It is therefore unfortunate that the Plan, and the Obama Administration, accept financial conglomerates as the status quo and appear, at least until recently, oblivious to their dangers and reluctant to rein them in. Therefore, additional crises generated by the conglomerates, likely even worse than the one we have just lived through, await us in the future, unless these institutions are broken up.