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The Controversy Over Systemic Risk Regulation

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INTRODUCTION

There is widespread support for a systemic risk regulator in the United States and in Europe. There is, however, less agreement on which existing or new organization(s) should assume the task of regulating against systemic risk, on the authority such a regulator should have, or on the work such a regulator should undertake. In general, the debate about enhanced systemic risk regulation has been about whether central banks or other regulators should be required to assess systemic risk or whether such an assessment should be the job of others. The debate includes the issue of whether a systemic risk regulator should also be a prudential regulator and whether the regulator that assesses systemic risk should also have the authority to mandate changes in the financial markets or changes to financial institutions when dangers to the markets emerge. Much of this debate has been in the form of turf warfare between central banks and other regulators, and therefore the discussions have been less enlightened than one would have hoped for given the magnitude of the problems uncovered during the financial meltdown of 2008.

In the United States, the primary issue regarding a systemic risk regulator is whether the Federal Reserve Board ("Fed") should become the systemic risk regulator or whether such new powers conflict with the Fed's role with respect to monetary policy or with the Fed's prudential regulation of individual bank holding companies.[1] As an alternative or as an addition to making the Fed a systemic risk regulator, a Council of Regulators has been proposed as a replacement for the President's Working Group.[2] Similarly, in Europe there has been a debate over whether

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1. *Regulatory Restructuring: Balancing the Independence of the Federal Reserve in Monetary Policy with Systemic Risk Regulation: Hearing Before the Subcomm. on Domestic Monetary Policy and Technology of the H. Comm. on Financial Services*, 111th Cong. (2009) (statement of John B. Taylor, Professor of Economics and Senior Fellow of Hoover Institution, Stanford University).

2. After the stock market crash of 1987, the President appointed a Working Group on Financial Markets comprised of the Secretary of Treasury, and the Chairmen of the Securities and Exchange Commission, the Commodities Futures Trading Commission,

the European Central Bank ("ECB"), national central banks, or other regulators should be given systemic risk regulatory responsibilities.[3] One of the problems with deciding on an appropriate risk regulator is that systemic risk can emerge from various corners of the financial system. It can be generated by financial firms or products beyond the purview of a central bank's expertise or its usual jurisdiction. Further, in the eyes of many critics, the Fed did a poor job of predicting or preventing the 2008 financial meltdown.[4] Moreover, in the United Kingdom, where the Financial Services Authority ("FSA"), rather than the Bank of England, was responsible for the regulation of financial firms, the FSA was equally inept.

This author believes that any systemic risk regulator should be an independent agency without responsibilities that would conflict with its duties to examine and make recommendations with regard to systemic risks. Further, important systemic risks will necessarily remain within the purview of existing regulators unless the United States moves to a model of regulation by many fewer agencies, a politically unlikely development. Some of these regulators currently are independent agencies, but some are not. Also, although the Council of Regulators contemplated by many of the pending reform proposals would be an improvement over the President's Working Group, a committee of agency heads is unlikely to effectively blow the whistle on dangerous products or activities in the financial markets. Further, one or more agencies need to have the power to enforce any decision that a serious systemic risk exists. To suppose that some super-regulator or the Fed will have the sole power to enforce recommendations with regard to risky products or conduct in the financial markets, in our politically fractured and captured world is, in the author's opinion, unrealistic.

Accordingly, the author recommends the creation of a new agency. This new agency could be modeled on the Office of Management and Budget ("OMB"), the Government Accounting Office ("GAO"), or the National Transportation Safety Board, but independent of the Executive and Congressional Branches. It could investigate and analyze systemic risks and propose action to the President, Congress, or individual regula-

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and the Fed to agree on intermarket mechanisms to prevent another crash. Exec. Order No. 12,631, 53 Fed. Reg. 9421 (Mar. 18, 1988).

3. José Manuel González-Páramo, Member of the Exec. Bd. of the Eur. Cent. Bank, Presentation of the Report "Observatorio sobre la reforma de los mercados financieros 2009, realizado por la Fundación de Estudios Financieros," (Jan. 22, 2010), *available at* http://www.ecb.europa.eu/press/key/date/2010/html/sp100122.en.html.

4. Robert Weissman, *Deregulation and the Financial Crisis*, HUFFINGTON POST, Apr. 12, 2010, http://www.huffingtonpost.com/robert-weissman/deregulation-and-the-fina_b_82639.html.

tory agencies, including the Fed. This systemic risk regulator should consult with the Council of Regulators, but implementation of any recommendations should be left to the responsible agencies, to the Executive, or to Congress. One of the problems with a more radical regulatory reform, that may well be in order, is that blame for the financial meltdown has been a political hot potato and many officials who were responsible have not yet accepted responsibility. Given the complex structure of the European Union ("EU"), it would seem that a systemic risk regulator for Europe would similarly have to be an advisory body within the framework of the E.U. The E.U. Commission has proposed such a regulator.[5]

Part I will define systemic risk and the various proposals for a systemic risk regulator that have been put forth in the United States. Part II will discuss the conflicts of interest between assessing systemic risk and acting as a prudential regulator. Part III will outline the consideration of similar issues in Europe. Part IV will delineate a proposal for a new systemic risk regulator.

I. PROPOSALS FOR A SYSTEMIC RISK REGULATOR

A. Defining Systemic Risk

There are various types of risk in the capital markets, both to individual firms and to the system as a whole.[6] A financial product can pose counterparty credit risk, operational risk, and market risk.[7] Undue concentrations, excessive leverage, or internal control failures can cause a financial firm to collapse. Systemic risk is risk to an entire financial system or market, as opposed to the collapse of one firm within that market.[8] This risk comes about because firms price only internal costs and benefits and not risks to the financial system.[9] Therefore, individual firms find it profitable to take on more risk and leverage than is socially optimal.[10] Furthermore, the financial meltdown of 2008 demonstrated that financial contagion spread from the United States to other countries because there

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5. *Commission Communication for the Spring European Council, Driving European Recovery*, COM (2009) 114 final (Apr. 3, 2009), *available at* http://ec.europa.eu/archives/commission_2004-2009/president/pdf/press_20090304_en.pdf.

6. Christine M. Cumming & Beverly J. Hirtle, *The Challenges of Risk Management in Diversified Financial Companies*, 3 J. FIN. TRANSFORMATION 89, 89 (2001).

7. Kathleen A. Scott, *Addressing the Conditions Leading to System Risk on a Global Basis*, N.Y. L.J., Mar. 18, 2009, at 2.

8. *Id.* at 3.

9. Matthew Beville, Comment, *Financial Pollution: Systemic Risk and Market Stability*, 36 FLA. ST. U. L. REV. 245, 245 (2009).

10. *Id.* at 246.

was no international architecture to prevent global crises from erupting.[11] National financial systems, like individual financial firms may thus become over-leveraged and take risks that will then infect the global markets.

The current financial crisis was sparked by unregulated or poorly regulated securitization of mortgages and credit default swaps.[12] Additional related causes, such as failures by credit rating agencies ("CRA"s) to appropriately price rated securities, also were important. Systemic risk can also arise from poorly regulated financial institutions or speculative market conduct. Some of the tools currently in place to guard against the collapse of individual firms, such as capital adequacy rules by banking and securities regulators, did not ward off the collapse of individual firms that were important to the financial system. In fact, over-the-counter ("OTC") derivatives markets were not regulated at all. This paper will address the issue of whether the current proposals for a systemic risk regulator are likely to prevent systemic shocks to the financial markets in the future.

B. The Administration's Proposals and Counter-proposals

In March 2009, the U.S. Secretary of the Treasury outlined a framework for regulatory reform, initially focusing on containing systemic risk.[13] This framework was important for what it covered, and also for the issues that it did not address. There were five components of the Treasury's framework: 1) a single independent systemic regulator with responsibility for systemically important firms, critical payment and settlement systems; 2) higher capital and risk management standards for systemically important firms; 3) registration of all hedge fund advisers of a certain size with the SEC; 4) a comprehensive framework of oversight, protections and disclosure for the OTC derivatives market; and 5) new requirements for money market funds to reduce the risk of rapid withdrawals.[14]

An alternative proposal for a Council of Regulators was put forth by some Republicans and advocated by the Chairman of the Federal Deposit

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11. DICK K. NANTO, U.S. CONG. RESEARCH SERV., THE GLOBAL FINANCIAL CRISIS: ANALYSIS AND POLICY IMPLICATIONS 23 (2009), *available at* http://www.fas.org/sgp/crs/misc/RL34742.pdf.

12. *See generally* Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure,* 41 CONN. L. REV. 1327, 1327 (2009).

13. *See* Press Release, Dep't of Treasury, Treasury Outlines Framework for Regulatory Reform (Mar. 26, 2009), *available at* http://www.financialstability.gov/latest/tg72.html.

14. *Id.*

Insurance Corporation ("FDIC"). This Council would address issues that pose risks to the financial system as a whole and would include a Chairman of the Council, the Secretary of the Treasury, Chairman of the Fed, the Chairman of the FDIC, the Chairman of the National Credit Union Administration, the Chairman of the Securities and Exchange Commission ("SEC") and the Chairman of the Commodity Futures Trading Commission ("CFTC").[15] The Chairman of the Council of Regulators would serve as the principal advisor to the President on matters related to overseeing, monitoring, and preventing systemic risk and would make recommendations to the Council on systemic risk regulatory policy.[16] This proposal would centralize the responsibility for supervising systemically important financial institutions and would identify and mitigate the build-up of risk by individual firms. The Council would identify systemically important institutions, practices and markets, implement actions to address those risks, ensure information flow, analyze and make recommendations on potential systemic risks, set capital adequacy standards, and ensure that key regulators apply those standards. The Council would have the authority to overrule or force actions on behalf of other regulators.[17]

Other Republican proposals would limit the Fed's authority to overseeing monetary policy and transfer the Fed's authority for prudential regulation of bank holding companies to a new financial institutions regulator. In addition, the Republicans proposed a Market Stability and Capital Adequacy Board to identify systemic risks in the entire financial system. This, in addition to the Council members described above, would include five private, presidentially-appointed members with no more than three members from the same political party.[18] Further, one of the eleven members would be reserved for someone who had served as a state insurance commissioner or supervisor.[19]

In June 2009, the Obama Administration issued a White Paper on Financial Regulatory Reform,[20] followed by legislative texts to implement

15. Financial System Stabilization and Reform Act of 2009, S. 664, H.R. 1754, 111th Cong. (2009).

16. *Id.* at § 112(a)(1)(A).

17. *Regulation and Resolving Institutions Considered "Too Big To Fail": Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (May 6, 2009) (statement of Sheila C. Bair, Chairman, FDIC)

18. Press Release, Committee on Financial Services, Republicans Announce Comprehensive Regulatory Reform Plan (June 11, 2009), *available at* http://republicans.financialservices.house.gov/index.php?option=com_content&task=view&id=600.

19. *Id.*

20. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM A NEW FOUNDATION:

the White Paper.[21] The Administration's proposals would require the Fed to designate all large, highly leveraged and substantially interconnected financial companies as Tier 1 financial holding companies ("FHCs").[22] This designation would not be limited to bank holding companies, and it could extend to foreign financial institutions with sufficient operations in the United States.[23] The Fed would then regulate FHCs. Such regulation would encompass capital adequacy standards, the ordering of corrective action, liquidity standards and overall risk management requirements. Nevertheless, a working group headed by the Treasury would conduct a reassessment of regulatory capital requirements for Tier 1 FHCs and others.[24] This reassessment would necessarily be in the context of the Basel Committee standards for bank capital adequacy. Although the Fed would essentially become the primary federal systemic risk regulator, a great deal of systemic risk regulation would in fact fall to others because the White Paper would leave most of the existing federal financial regulators in place.[25]

A new Financial Services Oversight Council ("Council")[26] would have the Secretary of the Treasury as its Chairman and would have as its members the chairs of the federal financial regulatory agencies.[27] The Council would act essentially as an advisory group responsible for identifying gaps in regulation and detecting emerging risks. It would, however, have no power to take direct action or to compel the Fed to do so.[28] The Council would replace the President's Working Group.

REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

21. *See* FinancialStability.gov, U.S. Dep't of the Treasury, Proposed Text of Bank Holding Company Modernization Act of 2009, *available at* http://www.financialstability.gov/docs/regulatoryreform/07222009/titleII.pdf .

22. DEPARTMENT OF THE TREASURY, *supra* note 20.

23. *Id.*

24. *Id.*

25. The Office of Thrift Supervision and the Comptroller of the Currency would be folded into a new government agency, the National Bank Supervisor. An Office of National Insurance would be created, but it would have no real power other than to enter into international agreements and facilitate greater cooperation on insurance regulation by the states. A Consumer Financial Protection Agency would be created to protect consumers of financial services, and this agency would take away some powers from the Fed and other agencies, but this controversial proposal has little to do with systemic risk regulation.

26. *See* FinancialStability.gov, U.S. Dep't of the Treasury, Proposed Text of Financial Services Oversight Council Act of 2009, *available at* http://www.financialstability.gov/docs/regulatoryreform/07222009/titleI.pdf.

27. Financial Stability Improvement Act of 2009, H.R. 3996, 111th Cong. (2009).

28. *Id.*

Various tasks related to systemic risk would remain with the SEC, the CFTC, or others. Advisers to private pools of capital, including hedge funds, private equity funds and venture capital funds would be required to register with the SEC if their assets under management exceed some specified threshold. Although the funds would not be required to register, and the connection between hedge funds in particular and systemic risk is more a matter of suspicion than proof, information regarding assets under management, leverage, off-balance sheet exposures and other matters related to systemic risk would have to be reported to the SEC. The SEC would then share such reports with the Fed.[29] The White Paper also assigns to the SEC the task of continuing with plans to strengthen the regulatory framework for money market mutual funds and the regulation of CRAs, including, wherever possible, the reduction of the use of ratings in regulations.[30]

Neither the White Paper, nor the proposed legislation implementing it, would merge the SEC and the CFTC or clarify their respective areas of jurisdiction with regard to financial futures products. Rather, the SEC and the CFTC would be required to harmonize futures and securities regulation, and if unable to do so, the Secretary of the Treasury would decide any jurisdictional disputes.[31] Also, the SEC and the CFTC would be given unlimited authority to police market abuses involving over-the-counter ("OTC") derivatives.[32]

The White Paper requested the SEC and the CFTC to identify conflicts in statutes and regulations with respect to similar types of financial instruments and explain why such differences are essential to achieve underlying policy objectives or to make recommendations for change.[33] After hearings, these agencies issued such a report on October 16, 2009.[34] Among the topics that specifically relate to systemic risk discussed in the report were oversight of new products, segregation, insolvency, margin regulations, and clearing systems.

29. On April 29, 2009, the E.U. proposed legislation that would require European hedge fund managers with 100 million Euros or more under management to report regularly to their competent national authorities on their main investments, performance and risks, and funds would be subject to rules on minimum capital, risk management and auditing.

30. DEPARTMENT OF THE TREASURY, *supra* note 20.

31. *Id.*

32. *See Bill Would Split Oversight Between SEC, CFTC; Goal to 'Preserve' Markets*, 41 Sec. Reg. & L. Rep. (BNA), at 1397 (July 27, 2009).

33. DEPARTMENT OF TREASURY, *supra* note 20, at 50–51.

34. *See* U.S. SEC. & EXCH. COMM'N & U.S. COMMODITY FUTURES TRADING COMM'N, A JOINT REPORT OF THE SEC AND THE CFTC ON HARMONIZATION OF REGULATION (2009), *available at* http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf.

In order to contain systemic risk, the White Paper would require all standardized OTC derivatives to be cleared through central counterparties that impose margin requirements and more stringent capital requirements on OTC derivatives dealers.[35] Also, standardized derivatives contracts would be required to be transacted on regulated exchanges or electronic trading platforms.[36] These recommendations are strongly endorsed by the Fed.[37]

An important component of the Administration's proposal is the creation of a new financial products consumer protection agency. The White Paper proposed that the Council head this agency. The pros and cons of creating such an agency will not be discussed in this article. Although it can be argued that "the lack of meaningful federal oversight of consumer credit exacerbated the off-loading of risk to investors," sending a shock wave across the financial markets.[38] In the author's view, the creation of a financial consumer protection agency is unlikely to mitigate systemic risk. On the other hand, the Fed's lax attitude toward consumer credit was symptomatic of its deregulatory philosophy.

Another important component of financial regulatory reform is resolution authority for large, interconnected financial firms, outside of the bankruptcy courts.[39] Since the Administration's proposals were floated, a draft law from the Treasury and the House Financial Services Committee would give the Fed sweeping powers over systemically significant firms short of winding up.[40] For example, the Fed could order a firm to sell a risky division or stop dangerous trading activity, since the draft bill allows the Fed to require any systemically significant company to "sell or

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35. DEPARTMENT OF THE TREASURY, *supra* note 20.

36. *See* Dawn Kopecki, *JPMorgan, Hedge Funds May Lose as Derivatives Proposal Advances,* BLOOMBERG, Aug. 12, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=a4bIfOU56Oxo.

37. *Over-the-Counter Derivative: Hearing Before Subcomm. on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (2009) (testimony of Patricia White, Assoc. Director, Division of Research and Statistics).

38. *See* INVESTORS' WORKING GROUP, CFA INST. CTR. FOR FIN. MKT. INTEGRITY AND COUNCIL OF INST. INVESTORS, U.S. FINANCIAL REGULATORY REFORM: THE INVESTORS' PERSPECTIVE 18 (2009), *available at* http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf.

39. *See* FinancialStability.gov, U.S. Dep't of the Treasury, Proposed Resolution Authority for Large, Interconnected Companies Act of 2009*, available at* http://www.financialstability.gov/docs/regulatoryreform/title-XII_resolution-authority_072309.pdf.

40. *See* Tom Braithwaite et al., *Draft Law Gives Fed Sweeping Powers,* FIN. TIMES, Oct. 28, 2009, at 1.

otherwise transfer assets or off-balance sheet items to unaffiliated firms, to terminate one or more activities or to impose conditions on the manner in which the identified financial holding company conducts . . . activities."[41]

The White Paper's proposals were controversial, and arguments broke out not only between the Administration and members of Congress, but also among various federal regulators over the merits of taking powers away from the Fed, giving more powers to the Fed, creating a Council of Regulators, with or without enforcement powers, and many other matters. Political realities militate against merging the SEC and the CFTC or creating a federal insurance regulator. Considered together with those realities, the White Paper's compromise proposal for moving some authority to or from particular agencies met resistance by the agencies, their Congressional oversight committee members, as well as industry lobbyists.[42]

Subsequently, the House passed regulatory reform legislation,[43] and Senator Dodd proposed a companion Senate bill.[44] The House bill tracked the White Paper's proposals in most important respects. It would create a Council of regulators to oversee systemic risk and prepare strategies for threats to the stability of the U.S. financial system.[45] Primary financial regulatory agencies would be empowered to enforce prudential standards. The Fed would have the power to treat systemically important non-bank financial holding companies as if they were bank holding companies.[46] OTC derivatives would be forced into clearinghouses and on to exchanges. An independent financial products consumer protection agency would be created. A new resolution authority would be created for bank holding companies or any systemically important financial company whereby the FDIC would act as receiver according to bank resolution rules rather than bankruptcy rules.

The Senate bill also would assign systemic risk assessment functions to a Council, chaired by the Secretary of the Treasury, but it would in addition create an Office of Financial Research within the Department of the Treasury to act as an advisor to the Council. This Office would collect and analyze financial data.[47] Two important differences between the

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41. *Id.*
42. *Id.*
43. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009).
44. Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2009).
45. H.R. 4173.
46. *Id.*
47. S. 3217.

House and Senate bills relating to systemic risk concern resolution authority and the financial consumer protection agency. The Senate bill would set up an Orderly Liquidation Authority Panel composed of three judges from the U.S. Bankruptcy Court for the District of Delaware that could appoint the FDIC as a receiver. The Senate bill also would place the financial consumer protection agency inside the Fed as an independent agency.

In view of the partisanship on display in Washington, it is difficult to predict whether there will be any meaningful regulatory reform during this session of Congress. Further, both the House and Senate bills would result in only incremental changes in the structure and powers of financial regulators. Nevertheless, it can be expected that existing regulators will exercise their powers to increase capital adequacy requirements, mandate risk management systems and otherwise guard against systemic risk more forcefully.

C. Conflicts between Systemic and Prudential Regulation

There are several reasons why proposals that give the Fed the responsibility for being the systemic risk regulator have generated opposition. Many observers feel the Fed was a systemic risk regulator and it failed to prevent the speculative boom in structured finance products that led to the financial meltdown. They charge that the Fed's easy money policy enabled financial firms to amass large concentrations of risky and complex securitized products.[48] Alan Greenspan, as Chairman of the Federal Reserve Board, embraced derivatives since he believed they were good for banks because they spread risk.[49] He argued that derivatives were essential to the stability of the banking system and therefore should not be regulated.[50] Further, he "attributed the substantial increase in U.S. wealth and productivity in part to the derivatives markets."[51] However, by keeping interest rates too low, the Fed fueled a stock market bubble and then a credit bubble.[52]

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48. Braithwaite et. al., *supra* note 40, at 25.

49. David Blake, *Greenspan's sins return to haunt us,* FIN. TIMES, Sept. 19, 2008, at 17.

50. Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives,* 75 U. CIN. L. REV. 1019, 1023–24 (2007).

51. Kai Kramer, Comment, *Aren't We Still in the "Garden of the Forking Paths"? A Comment on Consolidation of the SEC and CFTC,* 4 HOUS. BUS. & TAX L.J. 410, 417 (2004).

52. *See* Greg Ip, *In Treating U.S. After Bubble, Fed Helped Create New Threats,* WALL ST. J., June 9, 2005, at A1.

Other critics believe that the Fed has too much power now and should not get more power without greater congressional oversight.[53] More than 250 Republicans co-sponsored a bill that would allow the GAO to conduct audits of Fed decisions on monetary policy.[54] Members of this group argued that the Fed's role should be limited to overseeing monetary policy and the payments system, and regulatory responsibilities and systemic oversight detract from focus on fighting inflation.[55]

Others have focused on the conflicts of interest inherent in having a prudential regulator of financial holding companies also act as a systemic regulator. As the prudential regulator of bank holding companies and Tier 1 FHCs, would the Fed have the backbone to put an end to the sale of financial products or to financial businesses that are lucrative for the banks? Alan Greenspan not only did not do so, but encouraged the expansion of derivatives trading because it seemed to enhance the balance sheets of banks.[56] It has been argued that the capital rules of the Basel II accords, endorsed by the world's leading central banks increased market instability during the financial crisis.[57] While a different Fed Chairman, less enamored of deregulation than Alan Greenspan, might take a different approach to financial products that increase the earnings of banks, the conflict between systemic regulation, prudential regulation and monetary policy are difficult to reconcile. These conflicts have become worse since the bailout because Wall Street banks are buying massive amounts of securities to help stabilize the markets.[58] Some advocates of giving the Fed enhanced powers and responsibilities as a systemic regulator have therefore argued that prudential regulation of banks should be transferred to a consolidated federal bank regulator.[59] One additional reason given for not making the Fed the systemic regulator is that the Fed favors

53. Edmund L. Andrews, *Two Authorities on Fed Advise Congress Against Expanding Its Power,* N.Y. TIMES, July 10, 2009, at B3.

54. *Id.*

55. Jon Hilsenrath, *Revamp Could Hurt Central Bank, Warns Head of Philadelphia Fed,* WALL ST. J., July 28, 2009, at A6; John Taylor, *Fed Needs Better Performance, Not Powers,* FIN. TIMES, Aug. 10, 2009, at 7.

56. Blake, *supra* note 49.

57. Beville, *supra* note 9, at 249. All of the largest investment banks including Bear Stearns, Goldman Sachs, and J.P. Morgan were using Basel II net capital calculations.

58. Brooke Masters & Henny Sender, *Wall St Profits from Fed Role,* FIN. TIMES, Aug. 3, 2009, at 1.

59. *Reducing Systemic Risk in the Financial Sector: Before the H. Comm. on Fin. Serv*., 111th Cong. (2009) (testimony of Alice M. Rivlin, Senior Fellow, Brookings Institution); Alan Blinder, *Early Warnings System, Run by the Fed*, N.Y. TIMES, July 26, 2009, at BU5; Robert C. Pozen, *Systemic Risk and the Fed,* WALL ST. J., July 9, 2009, at A13; Mark Warner, *America Needs A Single Bank Regulator*, FIN. TIMES., Aug. 6, 2009, at 11.

secrecy over public disclosure and would not be sufficiently transparent.[60]

The Administration's proposals set off a turf war. Some agencies, together with their congressional oversight committees, are afraid of losing power; thus, various arguments have been raised in favor of the status quo.[61] These arguments are generally in the form of advocating that a Council of Regulators should become the systemic risk regulator.[62] Yet, the President's Working Group has been in existence since 1987 and it has been largely ineffectual in identifying products or practices that pose risks to the financial system.[63] A committee of regulators frequently engaged in turf warfare is unlikely to solve system wide risks to the financial markets.

The Securities Industry and Financial Markets Association ("SIFMA") has recommended that all important financial institutions and systems should be subject to a systemic risk regulator, regardless of their charter or primary functional regulator.[64] The systemic risk regulator should have access to information about any institution that might be systemically important, as it determines. Further, market sectors where individual firms are not systemically important, but where such firms in the aggregate may have a significant impact on systemic risk, should be included within the purview of a systemic risk regulator.[65] According to SIFMA, systemically important institutions are those likely to have "serious adverse effects on economic conditions or the financial stability of other entities if they were allowed to fail."[66] Although SIFMA endorsed

60. INVESTORS' WORKING GROUP, *supra* note 38, at 25.

61. Stephen Labaton, *Regulators Spar for Turf in Financial Overhaul*, N.Y. TIMES, July 25, 2009, at B1; Sarah O'Connor, *Geithner Urges End to 'Dumb Regulation'*, FIN. TIMES, July 25, 2009, at 7; *see also* Kara Scannell, *Big Companies Go to Washington to Fight Regulations on Fancy Derivatives*, WALL ST. J., July 10, 2009, at B1.

62. *Regulation and Resolving Institutions Considered "Too Big to Fail": Hearing Before the S. Comm. On Banking, Housing, and Urban* Affairs, 111th Cong. (2009) (statement of Sheila C. Bair, Chairman, FDIC); Mary Shapiro, Chairman, Sec. & Exch. Comm'n, Address to the Investment Company Institute: Building a Stable and Efficient Financial System (May 8, 2009), *available at* http://www.sec.gov/news/speech/2009/spch050809mls.htm.

63. *See generally* John P. Hunt, Hedge Fund Regulation: The President's Working Group Committees' Best Practices Reports—Raising the Bar but Missing Risks 9 (June 2008) (unpublished manuscript), http://www.law.berkeley.edu/files/HedgeFundRegulationJune08-21(1).pdf.

64. *See Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Hearing Before the H. Comm. on Fin. Serv.*, 111th Cong. 96 (July 17, 2009) (statement of Randolph C. Snook, Executive Vice President of SIFMA).

65. *Id.* at 97.

66. *Id.*

a single oversight body as a systemic risk regulator, it was neutral as to whether the Fed should be that body.[67]

Most commentators share the opinion that the Fed should remain independent and any systemic risk regulator should be independent.[68] The meaning of independence in this context is generally left undefined, however. Does it mean independent from the Executive and/or Congressional branches of government, or does it mean independent from regulated entities? Such entities generally exert their influence through the congressional oversight committees for the financial regulators, and given the corrupting influence of campaign contributions on U.S. politics, such influence is difficult to resist. Although a stable source of funding is sometimes considered a way for a financial regulator to remain independent, some argue that such funding necessarily leads to the agency's loss of independence if it comes from regulated entities. As an example, the Fed has been criticized for the heavy influence that banks have on its governance.[69]

II. THE EUROPEAN DEBATE

The E.U. Commission issued a Communication in May 2009 recommending that the European Council:

> 1) endorse the creation of a new European Systemic Risk Council ("ESRC") chaired by the President of the ECB and composed of governors of national central banks, the chairpersons of the three European Supervisory Authorities and a member of the Commission . . . [and]
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> . . . .
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> 2) agree on the establishment of a new European System of Financial Supervisors ("ESFS") composed of three new European Supervisory Authorities to develop common supervisory approaches and a single set of harmonized rules for all financial firms . . . .[70]

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67. *Id.* at 93.

68. *See The Value of Bank Independence; Critics Should Realize Central Bank Did Wrong Job Well*, FIN. TIMES (London), Aug. 3, 2009, at 6; *see also* David Wessel, *Experts Tell Congress to Lay Off the Fed,* WALL ST. J., July 16, 2009, at A3; Letter from Karl J. Ege, Chair, ABA, Section of Business Law, to The Honorable Barney Frank (Apr. 29, 2009), *available at* http://meetings.abanet.org/webupload/commupload/CL116000/newsletterpubs/SystemicRiskLetter.pdf.

69. INVESTORS' WORKING GROUP, *supra* note 38, at 2.

70. Commission of the European Communities, *European Financial Supervision*, at 15, COM (2009) 252 final (May 27, 2009), *available at* http://ec.europa.eu/ intenl_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf.

The role of the ESRC would be to collect and analyze information in order to monitor and assess potential threats arising from macro-economic developments and developments within the financial system as a whole.[71] The ESRC would identify and prioritize systemic risks and then issue warnings, to make recommendations and to monitor the agencies responsible for taking remedial action.[72] The ESRC would not have legally binding powers, and would be accountable to the Council and European Parliament.[73] In the view of the Commission, Finance Ministers should not be members of this systemic risk regulator because such membership would blur the ESRC's role in providing independent technical analysis of macro-prudential risks.[74]

The E.U. currently has three Committees of Supervisors for different financial industry segments, which act as advisory committees to coordinate E.U. regulation. These are the Committee of European Banking Supervisors ("CEBS"), Committee of European Insurance and Occupational Pensions Committee ("CEIOPS") and the Committee of European Securities Regulators ("CESR"). These committees were created pursuant to the Lamfalussy process designed to streamline and integrate financial regulation.[75] The May Communication asserted that these committees had reached the limits of what they could accomplish and so they should be replaced by three new European Supervisory Authorities, one for banking, one for insurance and occupational pensions, and a securities authority. These new Supervisory Authorities would then be authorized to develop binding technical standards and to draw up interpretive guidelines in order to ensure a single set of harmonized rules. It would also ensure consistent application of E.U. rules to achieve a common supervisory culture with consistent practices. The Authorities would regulate CRAs and counterparty clearing houses, coordinate responses in crisis situations, collect micro-prudential information, and undertake an international role.[76] These three Supervisory Authorities would then be combined to form the ESFS.[77] The Supervisory Authorities should be designed to be independent and transparent.[78]

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71. *Id.* at 3.
72. *Id.*
73. *Id.* at 5.
74. *Id.* at 6.
75. *Id.* at 8 n.5. *See generally* Niamh Moloney, *The Committee of European Regulators and level 3 of the Lamfalussy Process*, *in* PERSPECTIVES IN COMPANY LAW AND FINANCIAL REGULATION 449 (Michel Tison, et al. eds., 2009).
76. Commission of the European Communities, *supra* note 70, at 9–11.
77. *Id.* at 13.
78. *Id.*

The May Communication paid some attention to the legal authority required to form the ESRC and the ESFS.[79] There has long been a debate over the question of whether E.U.'s wide regulators for financial services could be created without an amendment to the E.U. treaties providing for them.[80]

The Communication was based on a Report by a Group chaired by Jacques de Larosiere,[81] followed by a Communication by the Commission and a comment period.[82] The de Larosiere Group Report argued that while it supports an enlarged role for the ECB in macro-prudential oversight, it did not support any role for the ECB in micro-prudential oversight. Some of its reasons were rooted in the special problems of E.U. law and politics, while others resonated with the debates in the United States. The Group argued that adding micro-supervisory duties to the ECB's brief could impinge on its fundamental mandate of monetary stability.[83] Also, the ECB is not entitled to deal with insurance companies.[84]

The United Kingdom has frequently parted company with other E.U. countries with regard to financial regulation, so it is interesting that the U.K. has been supportive of the Commission's Communication, and in particular endorsed the idea of establishing the ESFS and the ESRB.[85] Within the U.K., the Treasury has argued for maintaining the existing regulatory structure where the Financial Services Authority is a unified regulator for all financial services, and the Bank of England is responsible for financial stability.[86]

Both the U.S. and the E.U. need to consider how to incorporate into domestic law the recommendations and decisions of the Financial Stability Board, which was created and enlarged by the G-20 to supersede the Financial Stability Forum. The mandate of the Financial Stability Board is "to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stabili-

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79. *Id.* at 8, 14.

80. *See* Gilles Thieffry, *The Case For a European Securities Commission,, in* REGULATING FINANCIAL SERVICES AND MARKETS IN THE 21ST CENTURY 222–23 (Eilís Ferran & Charles A.E. Goodhart eds., 2001).

81. JACQUES DE LAROSIÈRE ET AL., THE HIGH-LEVEL GROUP ON FINANCIAL. SUPERVISION IN THE EU (2009), *available at* http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf.

82. *Driving European Recovery*, *supra* note 5, at 4–5.

83. DE LAROSIÈRE ET AL., *supra* note 81, at 43–44.

84. *Id.*

85. HM TREASURY, REFORMING FINANCIAL MARKETS, 2009, Cm. 7667.

86. *Id.* at 11. Opposition parties, however, have other proposals. *See Britain: More to Do; Financial Reform,* ECONOMIST, July 25, 2009, at 55.

ty."[87] It has focused on critical reforms underway in a number of areas, including reducing the moral hazard posed by systemically important financial firms and expanding oversight of the financial system.[88]

III. THE CREATION OF A NEW SYSTEMIC RISK REGULATOR

The specifications for a systemic risk regulator in the United States would not be so difficult or so controversial if the regulatory system for financial institutions was not already so balkanized. Almost every study of the U.S. financial regulatory system has recommended consolidation of the plethora of agencies regulating financial institutions and products.[89] Although there have been different proposals for two peaks, three peaks or more peaks regulation, none of the studies recommend that the present system should remain in place. The Administration's proposals in this regard are exceedingly timid. Only the Office of Thrift Supervision would be abolished; the SEC and the CFTC would remain separate agencies; and insurance supervision would remain with fifty state regulators.[90] The Senate bill would further consolidate the banking agencies, however. The idea that the Fed should take on the responsibility of designating Tier 1 financial holding companies, act as their systemic regulator, and also continue to supervise bank holding companies as a prudential regulator is a substitute for more far reaching reform of financial regulation. Further, it is a poor substitute because it involves too many conflicts of interest and it is unlikely to be effective when some of the Tier 1 FHCs are regulated by the states and others by a variety of federal agencies. If the Fed were to shed its prudential regulatory powers, and a consolidated banking agency were to be created, I would be in the camp of believing the Fed could function as a systemic regulator. But if such a consolidation is not to occur, I believe a new systemic risk regulator should be created. Furthermore, if the United States makes the Fed its systemic regulator, it will be out of step with the ongoing reforms in the E.U., and international coordination may be more difficult as a result.

Unfortunately, the creation of a new systemic risk regulator would merely add to the excessive mix of federal regulators. But if appropriately structured, it could at least be objective and independent. The Inves-

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87. Financial Stability Board, http://www.financialstabilityboard.org.

88. *Id.*

89. U.S. GOV'T ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. REGULATORY SYSTEM (2009), *available at* http://www.gao.gov/new.items/d09216.pdf

90. Gail C. Bernstein, Matthew A. Chambers, Sara A. Kelsey & Martin E. Lybecker, *Are We Halfway There Yet? House Passes Major Financial Services Bill With Senate Expected to Act Early This Year*, 127 BANKING L.J. 12, 12 (2010).

tors' Working Group has proposed an independent systemic risk regulator that would supplement existing financial regulators, and would consist of a chair and four other members, all of whom would be Presidential appointees.[91] Its mission would include collecting and analyzing the exposures of financial institutions, whether banks or non-banks, as well as products and practices that could threaten the stability of the U.S. financial system and economy. It would undertake reporting on those systemic risks and recommending steps by regulators to reduce those risks.[92] This oversight would require aggregating and analyzing risk exposures across firms, securities instruments, and markets.[93] The Investors' Group would not give the systemic risk regulator the power to compel financial regulatory agencies to adopt regulations or otherwise halt systemic risks. But it would make regulators comply with its regulations or provide policy justifications for not doing so.[94]

The Office of Financial Research, proposed in the Senate bill, would be a step in the direction of creating a systemic risk monitor. This Office would collect data on behalf of the Council, standardize the types and formats of data reported and collected, perform research, and develop risk measurement tools.[95] It would, however, be a part of the Department of the Treasury, an Executive Branch Agency, and therefore it would not be an independent agency. Conceivably, it could develop a tradition of independence, similar to the culture of the Antitrust Division of the Department of Justice.

The author generally agrees with the concept proposed by the Investors' Working Group with an important exception. Their proposal contemplates that the systemic risk regulator would be accountable primarily to Congress.[96] In my experience, Congress is at least as political as the Executive branch,[97] and the systemic regulator needs to be independent and highly professional. How an agency can be independent of both Congress and the Executive and still be constitutional is a somewhat daunting challenge, but such independence in fact, if not in law, should be the objective. One way to achieve such independence is to provide the

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91. INVESTORS' WORKING GROUP, *supra* note 38, at 26.
92. *Id.* at 24.
93. *Id.*
94. *Id.* at 25.
95. Matt Cover, *Obama-Backed Financial Reform Bill Would Create New Bureaucracy with Power to Subpoena 'Any Data' from 'Any Financial Company,'* CNS NEWS, April 6, 2010, http://www.cnsnews.com/news/article/63756.
96. *Id.* at 26.
97. Congressional interference in financial regulation is generally based on lobbying by regulated entities and can be highly destructive of agency independence. A recent example is the outcry about mark-to-market accounting.

systemic regulator with stable funding sufficient to attract a professional staff of experts. But another factor is for the Executive and Congress to exercise restraint in interfering with the systemic regulator's work. It is conceivable that the inability of such a regulator to enforce its recommendations may make such restraint possible.

The GAO is a possible organizational model for a systemic risk regulator. The GAO is an independent, nonpartisan agency that investigates how the federal government spends taxpayer dollars. Among other things, at the request of a congressional committee or subcommittee, it audits agency operations, reports on how well government programs and policies are meeting their objectives. The GAO also performs policy analyses and outlines options for congressional consideration.[98] The head of the GAO, the Comptroller General of the United States, is appointed to a 15-year term by the President from a slate of candidates, and is subject to Senate confirmation.[99] This slate is composed of the Speaker of the House of Representatives, the President Pro Tempore of the Senate, the majority and minority leaders of the House and Senate, the Chairman and Ranking Member of the Senate Committee on Homeland Security and Governmental Affairs, and the Chairman and Ranking Member of the House Committee on Oversight and Government Reform.[100] Although this selection process is cumbersome, it is designed to ensure that the Comptroller is independent and nonpartisan. A similar selection process for the Chairman of a systemic risk regulator could be appropriate.

Some lessons could also be taken from the operation of the Office of Information and Regulatory Affairs ("OIRA") within OMB. Since OMB is a cabinet within the Executive Branch, the head of OMB is not independent.[101] However, the OIRA within OMB monitors agencies to implement government-wide policies and standards with respect to federal regulations and guidance documents. The OIRA also monitors the quality, utility, and analytic rigor of information used to support public policy, particularly with respect to cost/benefit analyses.[102] To some extent, OIRA is an Executive Branch analogue of OMB with regard to its interaction with Federal agencies.

Another possible model for a systemic risk agency is the National Transportation and Safety Board ("NTSB"), an independent federal

98. U.S. Gov't Accountability Office, About GAO, http://www.gao.gov/about/index.html.
99. *Id.*
100. U.S. Gov't Accountability Office, How the Comptroller General is Selected, http://www.gao.gov/about/cgprocess.html
101. The White House Office of Management and Budget, Information and Regulatory Affairs, http://www.whitehouse.gov/omb/regulatory_affairs/default.
102. *Id.*

agency that investigates every civil aviation accident in the United States and accidents in other transportation modes as well.[103] It has a board composed of five members appointed by the President, with a term of five years. No more than three of the five members can be of the President's party, and the President designates the Chairman and Vice Chairman for a term of two years.[104] Initially, the NTSB was dependent on the Department of Transportation for its funding and administrative support, but in 1975 all ties to that department were severed.[105] Although the NTSB has no regulatory authority, its "fiercely independent" identity allows it to maintain its credibility in investigating accidents, providing "careful and conclusive forensic analysis," and making recommendations to avoid future accidents.[106] Although neither GAO, OMB, nor the NTSB have the power to compel agencies to act or refrain from acting, they nevertheless are powerful actors within the Federal government and influence rulemaking and other policies. My vision of an appropriate systemic regulator is a similar type of agency—responsive both to Congress and the Executive—that could investigate and analyze financial data to determine whether systemic risks are emerging. This systemic regulator should have the power to advise financial regulators of dangers, and suggest mitigating actions, perhaps by forwarding its reports to the Council of Regulators. However, it would be the duty of the financial regulators, Congress and the Executive Branch to deal with implementing action. In the final analysis, the problem of dealing with systemic risk is a political problem. A systemic risk regulator cannot, and should not, bear all of the responsibility for preventing financial market meltdowns. But a good regulator could uncover dangers to the financial system and assign responsibility for preventing collapses to those charged with regulating financial institutions and markets. Although the Office of Financial Research that would be established by the Senate bill is a step in the direction, its independence and mission would have to be better articulated for it to function effectively.

CONCLUSION

The causes of the financial meltdown and ongoing recession are complex. At their root the causes are economic, such as government budget deficits and trade imbalances. But poor regulation made this crisis much

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103. Andrew W. Lo, *The Financial Industry Needs Its Own Crash Safety Board*, FIN. TIMES, Mar. 2, 2010, at 20.

104. 49 U.S.C. § 1111(b) (2006).

105 *See* Nat'l Transp. Safety Bd., NTSB History and Mission, http://www.ntsb.gov/Abt_NTSB/history.htm.

106. Lo, *supra* note 103.

worse.[107] Fixing the U.S. and E.U. regulatory systems is exceedingly difficult. But because there are genuine differences of opinion about what solutions are optimal, even if all of the experts were to agree on the needed reforms, politics stand in the way of a genuine reform. As critics of the de Larosiere Report remarked: "If even a group of experts cannot muster the courage to lay out imaginative blueprints, one can hardly expect politicians who have failed thus far to rise to the occasion and face head-on Europe's current challenges, to go beyond the timidity of the Report they commissioned."[108] Similar criticism can be leveled against the Obama Administration's proposals. Bowing to perceived political realities, the Treasury's program does very little to address the balkanized regulatory system, where financial firms can choose their regulators and compromise the agencies charged with their supervision. Meanwhile, the regulators do not have the funds, the staff, or the technology to keep pace with what is happening in the markets, and they are hobbled rather than emboldened by their Congressional oversight committees.[109]

If some firms are too big or too interconnected to fail, they should be dismantled.[110] This does not necessarily mean going back to the wall between investment and commercial banking, but it may require such measures. When the SEC was initially formed it was tasked with breaking up the public utility holding companies that contributed to the speculative stock market of the 1920s.[111] The U.S. taxpayer should never again be asked to bailout Wall Street, but the proposed reforms do not prevent such a reoccurrence. The purpose of credit and securities markets is to finance business, not to generate trading profits. But all of the regulatory agencies over the past quarter of a century have inevitably encouraged trading and speculation over capital formation and have emphasized efficiency over fairness.[112]

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107. *See* George Soros, *Do Not Ignore the Need for Financial Reform,* FIN. TIMES, Oct. 26, 2009, at 13.

108. Laurens Jan Brinkhorst, Jean-Victor Louis & René Smits, *De Larosière Report Fails to Tackle Main Issues* (Apr. 6, 2009), *available at* http://www.euractiv.com/en/financial-services/larosire-report-fails-tackle-main-issues/article-181014.

109. Edward Wyatt, *As Lawmakers Grapple with Financial Overhaul, They Call for More Studies*, NY TIMES, Mar. 17, 2010, at B3; Liz Moyer, *How Regulators Missed Madoff: Limited Resources, Fragmented Oversight and a Lack of Coordination Between Agencies Allowed the Alleged $50 Million Ponzi to Flourish*, FORBES, Jan. 27, 2009, *available at* http://www.forbes.com/2009/01/27/bernard-madoff-sec-business-wall-street_0127_regulators.html.

110. *See* Soros, *supra* note 107, at 11.

111. *See* SECHistorical.org, William O. Douglas and the Growing Power of the SEC, http://www.sechistorical.org/museum/galleries/douglas/academia.php.

112. CME Group, *Reform: What Does it Mean?*, OPEN MARKETS, Feb. 22, 2010,

The proposed reforms may lead to minor improvements in financial regulation, but they are unlikely to prevent another speculative securities market and its inevitable collapse. They are also unlikely to restore the confidence of investors in the fairness or safety of the markets. At one time, stock market panics affected only a few. But today, most Americans and many Europeans invest their retirement savings in the stock market.[113] Market collapses therefore lead to widespread pain. The public deserves better reform than the politicians are offering.

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http://openmarkets.cmegroup.com/features/reform-what-does-it-mean/.

113. MAURICIO SOTO, URBAN INSTITUTE, HOW IS THE FINANCIAL CRISIS AFFECTING RETIREMENT SAVINGS? (Mar. 9, 2009), *available at* http://www.urban.org/UploadedPDF/901283_retirement_savings_update.pdf.