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PANEL I (PART 2): DISCUSSION TRANSCRIPT

PROFESSOR BAIR: I enjoyed reading both of these papers very much. I think Jerry [Markham]'s paper explicitly and Heidi [Schooner]'s paper implicitly buttress the case for a need for revamping our current system of functional regulation with its multiplicity of regulators.

That certainly has been the conclusion that I've come to after 20 years working in Washington, as Professor Poser pointed out, both on the futures side, the securities side, and then Treasury, with dealing very closely with bank regulators, as well as insurance regulators. I was the lead administration person on the Terrorism Risk Insurance Bill. And something has got to give. The current system is just not compatible, as it could be with financial innovation facilitating the growth of financial supermarkets and the ability of financial institutions to provide the kinds of financial services their customers want, unfettered by artificial lines demarcating whether it's a future or security or bank product or what have you.

I think from a practical level, from the regulator's perspective, I think the current system increasingly produces very resource-straining turf fights. Jerry [Markham] catalogued the battles with the SEC and the CFEC, some of which I was personally involved in over the years. I used to think that regulatory competition was a healthy thing in terms of providing, producing greater efficiencies with regulation. I'm less convinced that there really is that much benefit from regulatory competition, because I think the turf fights are quite resource draining. I think OTC derivatives, swap market is a prime example where the debate really over the years has been dominated by who should be regulated, not whether or how they should be regulated. And we still don't really have a coherent regulatory policy towards OTC derivatives.

The system also currently does not work for multifaceted financial services firms. It's just not conducive. I'm not going to get into the charting wars that Howell [Jackson] and Jerry [Markham] both in their papers and presentations; they have catalogued all the different regulators. There are hundreds of them out there that you have to deal with if you're offering a full product line of financial services.

So there's just got to be a better way to build the mousetrap. I think it's going to be a very long process, unless there's some major, major crisis — you know, Enron tenfold — that would really precipitate a major revamping of the financial services regulatory structure, I think this is going to be a very long, drawn-out process, along the lines of the Glass-Steagall ten-to-fifteen-year process. But, nonetheless, it needs to be done and must be done if we are going to maintain our international competitive position.

Let me just briefly provide a few specific comments on the papers. I would certainly agree with Heidi that any proposals to move us to a more integrated model that would involve taking the supervisory powers away from the Fed is just a non-starter. First of all, they're not going to give it up. Second of all, I'm not sure they should give it up. I think it's very difficult in a clean distinction between being a central bank and being a bank supervisor. If you are a lender to your member institutions you obviously want some ability to provide some financial integrity oversight of those member institutions. More importantly, those institutions sufficiently large to propose systemic risk, I think you need some direct oversight and authority over those institutions. So I would agree that taking supervisory authority away from the Fed and putting them in a new FSA type structure would not work in the United States.

Similarly, putting it all, as Ireland has done, into the central bank, that's a non-starter as well. Again, I don't think the Fed would want that kind of supreme authority. And, two, I think that's just a really bad idea. Though it's not a perfect analog, if you look at the Ministry of Finance in Japan and the problems that that agency had when the Japanese economy hit the skids, they were totally incapable and I think still are, frankly, of showing flexibility and adaptability to deal with new economic changed circumstances. So I think that's a good — and, again, very well highlighted in Jerry's paper — how concentration of too much power in a single regulator can be a very, very bad thing.

Since we love our multiple regulators, let me just throw out a couple of ideas of how perhaps we could move to an integrated model but still have more than one regulator. Heidi and I were talking about this a bit last night. It was an idea we had kicked around at Treasury and I think we're looking very, very long term. But perhaps you could separate rule-making from super-

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visory function, so that you could have a single regulator for rule-making authority for the full financial services product line, but supervision would remain with the Fed. If you just overlay it and let OCC and OTS and the Fed and what have you maintain the supervisory authority over their institutions. But that would be one step, and I think that kind of builds on the coordinating council that the previous administration was trying to move us toward. But that might be a way where we could provide greater integration of financial services regulatory policy, but still not have a quite dramatic taking away of authority from a lot of pre-existing regulators.

Another possibility I think is less desirable might be a possibility would be to create a system of financially integrated supervision and regulation, but separated out according to institution size. It would give the Fed, they could be both the regulator and the supervisor for the very largest financial services company. You could maybe create a new agency with or without the FDIC — I'd have to think about that — for the smaller institutions. At least then . . . you wouldn't have one agency and completely in charge of everything. You would have two agencies which presumably would compete. But their responsibilities would be separated on kind of clean "how big is the institution" as opposed to whether you're doing securities or futures or banking or what have you.

An integrated model, though, in addition to Fed resistance, obviously if you have full integration, the question is what do you do with the securities and futures regulators, because presumably you would fold their function into the new integrated regulator. And I can only assume the SEC and the CFTC would be quite unhappy about that. And I think that is another real, very real issue that needs to be thought about. I mean, Gramm-Leach-Bliley, as Heidi [Schooner] outlined in her presentation, theoretically the Fed is the regulator for financial holding companies. But they basically have no authority to go in and oversee a securities firm. They must defer to the SEC on that. Or a futures firm, they must defer to the CFTC. Or a national bank the OCC, or a thrift, the OTS.

I mean, those kinds of balkanized lines were still maintained under Gramm-Leach-Bliley. So I think going to a truly integrated model where you would fold the SEC and CFTC, those types of functions into an integrated regulator would be a quite dramatic thing to happen, perhaps a good thing to happen in

the long term. But I think there would be a lot of political resistance to that.

That brings me to Jerry's paper. Unfortunately, he didn't get to it at the end, but he had some very interesting new paradigms. If we were going to scrap the current functional lines of securities and futures, he had some very interesting ideas for how we might reorganize the categories that we use to define the regulatory regime. And those were centered in large part along the sophistication of the institutions, their size, whether they were going only institution by institution or whether they were dealing with retail cost customers. Similarly for market regulation, whether they were institutional markets or public markets with retail small investor access. I agree with him, I think, if we were going to be designing a grand scheme, either the short term or long term, that those kinds of distinctions may make more sense than the current lines that we use. I would just have a few caveats. I'm not sure I would go quite as far as he would. I think that regardless of what market or what association you're regulating, no matter their size or sophistication — it's not going to surprise him to hear me say this — I think you always need anti-fraud and anti-manipulation authority.

Fraud is fraud, and you never want to be in a position where the institution that you're regulating has committed fraud and you've got to say you can't do anything about it.

I think that they're all — and Arthur Andersen comes to mind when I say this — I think there are certain types of fraud that perhaps can be handled better in a civil capacity through administrative regulatory proceedings and civil proceedings as opposed to the neutron bomb of the criminal proceeding. There are just situations where fraud works — civil courts and administrative regulatory agencies are better equipped to deal with certain types of cases. So I think whatever regime must always retain that civil anti-fraud authority.

Similarly, anti-manipulation. If you have markets that are setting prices that are relied upon by the general populace, even if those markets are dominated by institutions, I think regulators must retain that anti-manipulation authority. And finally, I also think that somebody — and again maybe this long-term needs to be the Fed — some federal financial regulator needs to be in charge of financial integrity oversight over institutions that are sufficiently large to pose systemic risk.

Let me just, in concluding, re-emphasize that I think this is going to be a very, very long-term process. I mean, we dealt with it at Treasury. Howell indicated the difficulties they had with just a very modest proposal of a coordinating council. And unless there's some industry political support for moving this ball forward — it's good policy — we talk about what good policy is, but unless there's some political push for it, it's not going to happen on the Hill.

I think some of the larger financial services firms are now getting into the fray with this and realize that it is in their business interest, in their competitive interest to push this forward, to work with the Treasury Department and others who have an interest in this, to move the ball forward in terms of regulatory restructuring.

I think there's some interim steps that can be taken. And I will say this now. I couldn't say it when I was at the Treasury Department, but now I'm in academia and I have no power to do anything about it. So I will say it and nobody will care anymore. But I do think the OCC and OTS should be merged. And I say that with the utmost respect for the leadership of both agencies. Jerry Hoff and Jim Gilling are top-notch regulators and their staffs are just absolutely the best. Unfortunately, because of bank consolidations, the number of charters is dwindling. Their revenue basis is becoming increasingly reliant on a few large institutions. This is a very dangerous situation for maintaining an autonomous independent regulator. I think by merging the two you would strengthen the agency, strengthen the prestige of the agency, strengthen its ability to deal with the institutions that hold national charters, whether thrift or bank.

I think this is a harder call, but I think the SEC and CFTC should probably be merged. Unlike the OCC and the OTS, which have very similar cultures and missions in terms of safety and soundness, the SEC and the CFTC have quite different cultures and different product lines and markets. . . . I'm old fashioned. I still recognize distinctions between risk management products and those offered for capital formation and investment. Nonetheless, I think there's sufficient overlap, especially with the institutions, the firms that they regulate, that it makes some sense to merge them.

I would say that with the SEC and CFTC the most important thing would be to make sure the CFTC is not simply subsumed in the SEC culture, but maintains its own separate approach

where it is needed, and separate vibrancy in whatever new commission might be created out of the merger and that that commission had individuals who understood derivatives markets and were sensitive to the different type of regulatory regime that currently applies to derivative markets.

I also think we need to have a national insurance charter, frankly. I think it should be optional, obviously. But I think, again for international competitive reasons, it's just going to have to happen. And I think the sixty-four million dollar question will be whether proponents of an optional national insurance charter can present a convincing case that . . . the new federal regulator, will be just as vigilant on consumer protection issues as the states have been.

I think the NAIC [National Association of Insurance Commissioners] is a top-notch agency. I dealt with them a lot when I was dealing with terrorism insurance. I think that is their front line of defense against a national insurance charter, is that it would hamper consumer protections. I'm not sure that is the case. I'm hoping to do some additional research in that area at U. Mass. [University of Massachusetts]. But I think a well constructed federal insurance charter with a good strong consumer protection program is an option that should be out there for a national insurance company, and frankly consumers. It's not clear to me why somebody in Massachusetts should have different consumer protections than somebody in Florida for so many of these products. The options should be out there for submission to a national regime.

And that takes care of my comments.

PROFESSOR POSER: Thank you very much. Ms. Bair.

We have about ten minutes more. I first would like to ask either one of the two first speakers whether they have any comments commenting on the commentary. And then I'll ask whether any members of the audience have any questions.

PROFESSOR SCHOONER: I would just add to what Sheila [Bair] already said. I think what Sheila [Bair]'s comments show in some ways is that significant improvements could be made without doing something as drastic as what the U.K. did with creating the FSA. We've got such a diverse system that moving a few things around could perhaps lead to significant benefits and maybe even cost savings. And we could still, arguably, if anybody believes that they exist, still have benefits of regulatory competition.

I think that in some ways it's possible that beginning to understand the nature of the substance of the regulation and how the substance of our financial institution regulation is evolving might drive that. Eventually we'll figure out that bank regulation is becoming a little bit more like securities markets regulation, and therefore some aspects of bank regulation may belong more appropriately in an SEC type organization; that a lot of what we do with insurance companies is very much like what we do for banks; and that there might be some shifting slowly over time in that way without doing anything drastic, which is politically not feasible.

PROFESSOR POSER: Are there any questions from the audience?

QUESTION FROM AUDIENCE: [Unintelligible]

PROFESSOR MARKHAM: Good question. The futures industry belonged to America until recent years. We dominated in every respect. Today Eurex is the largest commodity trading exchange in the world. I think our two exchanges are now third and fourth — I'm not sure, because of the LIFFE [London International Futures and Options Exchange] merger, how that went. But we're trailing the pack. Some people have attributed it to regulation. I don't, personally. I think they picked up on electronic trading and were able to out-compete us. But by the back door, our regulatory system sought to protect the exchange monopoly. So you had to trade on the exchange over here. The exchange had this capital interest in the memberships, so they couldn't allow anyone to trade electronically, because they'd lose the time and place advantage on the floor and that was the value of their membership. So that regulatory structure I think is what affected and allowed that competition to develop while they're hanging onto their exchange monopoly.

And we saw that happen, and Sheila [Bair], you may know better. I think the CFMA is probably a direct result of that outflow of that business. We tried to deregulate as much as we could to meet that competition.

MS. BAIR: I think it would be interesting, though. The SEC has been generally viewed as more regulatory than the CFTC on that score. I think a merged agency would have been less captive of the exchanges and perhaps more willing to facilitate electronic competition and off-board trading.

Of course, on the securities side we've had off-board trading for years and the exchanges and the OTC markets sit side by

side and they compete. And it does work pretty well. So I think on that score I would agree with you. It wasn't regulation. It was an unwillingness to anticipate and deal with the competitive threats to the exchanges.

QUESTION FROM AUDIENCE: For any of the panelists, do you see any interest in more increased regulation of the over-the-counter derivatives market or over-the-counter swaps market? To the extent they are engaged in by qualified participants, many of these other regulated industries are participating as counterparties in credit support providers.

PROFESSOR MARKHAM: The Feinsein Bill, I've heard, and I haven't had an update on the last few weeks, was trying, I think, to reimpose some regulation in the over-the-counter market.

Will it get anywhere? I don't know. This has been a political circus. Something may spin out of it. I don't know. There's certainly an impetus for it.

Is there something out there that we've got to worry about, something lurking in the bushes? I don't know. Possibly. But we've dealt with these problems over the years. We keep crying that the world's going to end if we don't do something, but as yet it hasn't. Maybe I'm just an optimist, but I don't have that fear of the unknown, I guess.

PROFESSOR SCHOONER: I think I have a little bit of a fear, but I don't think politically in the near term. The genie's somewhat out of the bottle on the swaps market, and to try to put any kind of comprehensive regulatory regime over at this point, I just don't think it's going to happen.

I do think, hopefully, one of the good things to come out of all this corporate governance, new initiatives and heightened sensitivities to the obligations of corporate boards of directors if they start asking more questions of end users who use these instruments: what is your exposure on these positions; why do they have these positions on; what's the leverage; what kind of risk scenarios has the CFO run? I mean, those types of probing questions from audit committees and boards of directors [are] probably the quickest and fastest way that we can put greater discipline into the types of positions and risks that less sophisticated end users may be taking on in those markets.

QUESTION FROM AUDIENCE: [Unintelligible]

PROFESSOR MARKHAM: I don't know, sir. I don't know that. I know there were Congressional hearings where they

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brought in the Enron board and looked at the outside directors, but I have no information.

PROFESSOR SCHOONER: I served with Wendy [Graham] and I would have to take exception to that characterization of her position. I'm unaware of any inquiry into her, what she did on the Enron board. The press reports I've read have indicated that she had been the one saying we need go talk to the SEC about this. Apparently, nobody acted on that.

Wendy [Graham] is a free-market economist by training. But she did believe in efficient regulation. And that was certainly my experience working with her. I think people have unfairly characterized her as anti any regulation. I don't think that's the case. I think she was for good cost benefit analysis and efficient regulation, but not no regulation.

PROFESSOR POSER: In Wendy Graham's defense, I'd have to say that none of the other directors did any more than she did.

Any other questions? Okay. I believe lunch is being served downstairs.