Regulatory Consolidation and Cross-Border Coordination
Challenging the Conventional Wisdom

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Introduction

The global financial crisis of 2007-2010 has generated calls for greater regulatory consolidation at the domestic level and greater regulatory coordination at the international level. In March 2008—shortly after the Bear Stearns collapse, though still several months before the failure of Lehman Brothers—then-Treasury Secretary Henry Paulson unveiled a “blueprint” to merge the Securities and Exchange Commission with the Commodity Futures Trading Commission and to consolidate the Office of Thrift Supervision (which oversees federally chartered savings and loan associations) into the Office of the Comptroller of the Currency (which oversees federally chartered banks).† Although the Obama administration ultimately dropped Paulson’s proposal for an SEC-CFTC merger, the Treasury Department’s July 2009 White Paper retained Paulson’s plan to consolidate the OTS into the OCC and sought to vest the Federal Reserve Board with consolidated supervisory authority over the largest U.S. financial institutions.‡ Both of

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these proposals passed the Senate in May 2010. Meanwhile, President Obama and other industrialized-world leaders are pushing for closer cross-border coordination among financial regulators, and the Group of 20 nations have set a December 2010 deadline for a new set of global banking rules (the so-called “Basel III”). The Obama administration has stated that the domestic and international aspects of its regulatory agenda are “consistent” with one another.

Scholars specializing in financial regulation have echoed the Obama administration’s assumption that domestic regulatory consolidation and international regulatory coordination are complementary—if not mutually dependent. Professor David Andrew Singer has written that the “fragmentation of accountability among U.S. regulators” is a “serious barrier to future efforts at international regulatory harmonization.” According to Singer, the “possible consolidation of U.S. regulatory agencies” is the only “glimmer of hope” for greater global cooperation.


6 See U.S. DEP’T OF THE TREASURY, supra note 2, at 80.

Lawrence Cunningham and David Zaring echo this sentiment, writing that the “fragmentation of authority” among banking regulators at the domestic level has “complicated . . . efforts to create common international supervisory standards.”

Professor John Coffee has written that “[p]erhaps . . . the best argument for consolidation” is that “it may be easier for a consolidated agency to . . . negotiate for ‘harmonized’ international standards than for a bifurcated structure to do so.” Numerous other scholars have repeated the conventional wisdom that domestic regulatory fragmentation impedes cross-border coordination.

Outside of the academy, the view that domestic regulatory fragmentation has hindered international cooperation is playing an increasingly prominent role in debates about the structure of financial supervision. A 2004 World Bank publication stated that one of the advantages of regulatory consolidation is that it “facilitates international


cooperation.” The Group of Thirty, a consultative group led by former Federal Reserve chairman Paul Volcker, recommended in January 2009 that countries “substantially simplify and consolidate” their regulatory structures and suggested that this step was “important[] for much greater levels of international cooperation and coordination.” In May 2009, the Committee on Capital Markets Regulation, a bipartisan panel whose members include business leaders and former government officials, reported that “the fragmented U.S. system of prudential supervision . . . impairs our ability to coordinate supervision internationally.” The panel concluded that the OCC, the OTS, the FDIC, the SEC, and the CFTC should “all be merged and consolidated.” Then-Secretary Paulson expressed a similar view in March 2008 when, in his blueprint for domestic regulatory consolidation, he stated that the merger of supervisory agencies would “enhance . . . international regulatory dialogue.”

The assumption that regulatory consolidation will facilitate cross-border coordination may seem so intuitive that scholars have failed to test it against the historical record. Instead, we have incorporated this conventional wisdom into our policy debates without every seriously questioning it. But as this Paper argues, the assumption does not stand up to scrutiny. Through case studies of banking, securities, and insurance

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11 See Jeffrey Carmichael, Summary of the Discussion, in ALIGNING FINANCIAL SUPERVISORY STRUCTURES WITH COUNTRY NEEDS 1, 3 (Jeffrey Carmichael, Alexander Fleming & David Llewellyn, eds., World Bank Inst., 2004).
14 Id. at 203.
regulation, this Paper will show that U.S. financial regulators are most likely to coordinate with their cross-border counterparts when domestic regulatory authority is fractured and when agency autonomy is under attack. Domestic regulatory consolidation does not “facilitate[] international cooperation”;\textsuperscript{16} to the contrary, it makes international cooperation much less probable.

This argument yields important implications for the study of international law and financial regulation. Scholars who seek to explain the shape of existing international institutions have already realized that a country’s domestic regulatory structure may affect its propensity and capacity to engage in cross-border coordination. But so far, scholars in international relations and international law have assumed that the correlation between domestic consolidation and international cooperation is positive. For example, Pierre-Hugues Verdier wrote recently that “the more domestic autonomy [regulators] have, the more likely they are to enhance international enforcement and harmonization of standards . . . .”\textsuperscript{17} Christopher Whytock reiterates the same supposition: “The more autonomy a legal or regulatory agency possesses in a given issue area or a given state, the more likely the agency is to engage in transgovernmental cooperation on the issue with foreign counterparts.”\textsuperscript{18} This Paper argues that Verdier and Whytock have correctly identified domestic regulatory consolidation as an important independent variable affecting the probability of cross-border coordination; however, I argue that the effect is the exact opposite of the effect that Verdier and Whytock predict.

\textsuperscript{16} Cf. supra text accompanying note 11.
\textsuperscript{17} Pierre-Hugues Verdier, Transnational Regulatory Networks and Their Limits, 34 YALE J. INT’L L. 113, 170 (2009).
This Paper’s argument also informs ongoing policy debates regarding regulatory consolidation. Domestic regulatory consolidation may be desirable for other reasons unrelated to its international effects, but the often-repeated argument that regulatory consolidation will facilitate further international cooperation is misguided. As policymakers determine the future of the financial regulatory structure, they must carefully weigh the costs and benefits of consolidation. Unless the conventional wisdom regarding agency consolidation and cross-border coordination is corrected, we run the risk that major decisions about regulatory structure will be made based on the illusion that regulatory consolidation will make international cooperation more likely.

Part I of this Paper presents three hypotheses regarding the relationship between consolidation and coordination. The null hypothesis holds that domestic regulatory consolidation has no effect on the probability of cross-border coordination. The majority view holds that domestic regulatory consolidation has a positive effect on the probability

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19 A vibrant debate about regulatory consolidation occurred in the United Kingdom in the run-up to the Financial Services and Markets Act 2000, which vested the Financial Services Authority (FSA) with the power to serve as the single regulator for banks, securities firms, and insurers. Clive Briault, The Rationale for a Single National Financial Services Regulator (Fin. Serv. Auth., Occasional Paper Series No. 2, May 1999), available at http://ssrn.com/abstract=428086, summarizes arguments in favor of the single-regulator model that emerged during that debate: regulatory consolidation leads to “economies of scale and scope,” id. at 18; “a . . . more efficient . . . allocation of regulatory resources across both regulated firms and types of regulated activities,” id. at 20; a check against regulatory arbitrage, id. at 22; and clearer lines of accountability, id. at 22-23. At the same time, regulatory fragmentation may lead to “beneficial competition” among agencies and may allow agencies to specialize in specific subject areas. See Richard J. Rosen, Switching Primary Federal Regulators: Is It Beneficial for U.S. Banks?, FED. RESERVE BANK OF CHI. ECON. PERSP., 3rd Quarter 2005, at 16, 31; see also id. (“My results imply that banks switching regulators . . . increased return without a rise in bank failures.”). A full analysis of the advantages and disadvantages of regulatory consolidation lies beyond the scope of this Paper. Rather, the Paper advances the limited—though significant—claim that the correlation between domestic consolidation and cross-border coordination does not run in the direction that the pro-consolidation camp contends.
of cross-border coordination. The alternative hypothesis holds that domestic regulatory consolidation has a negative effect on the probability of cross-border coordination. Part I also explains the case study methodology that this Paper will use to evaluate these three competing hypotheses empirically.

Part II tests these hypotheses through a case study of banking regulation. It begins with the Basel I negotiations in the 1980s and finds that the Federal Reserve used the Basel process to bypass domestic opposition from other regulatory agencies. It proceeds to show that when the Fed enjoys relative autonomy in a given issue area (e.g. liquidity requirements and holding company rules), it has adopted a go-it-alone strategy; by contrast, when the Fed shares authority in an issue area with the OCC and the FDIC, it tends to favor an internationalist approach. Part III extends the analysis to securities regulation. It finds that the SEC stymied efforts to apply Basel-style rules to the securities industry in the early 1990s (at least in part) because the Commission did not want to cede its domestic autonomy. Only after the Gramm-Leach-Bliley Act of 1999 offered opportunities for the Fed and the OTS to encroach upon the SEC’s regulatory autonomy did the SEC embrace efforts to establish global capital requirements for investment banks. Part IV considers the Treasury Department’s recent efforts to jumpstart international negotiations on insurance capital requirements. It explores the relationship between regulatory fragmentation at the domestic level and the Treasury Department’s decision to pursue its policy objectives through multilateral channels. Part V concludes by evaluating the empirical results of the case studies and analyzing the implications for scholars and policymakers. Ultimately, it is impossible to understand patterns of global
financial governance unless one understands the way regulators respond to domestic fragmentation.

I. Three Theories of Cross-Border Coordination Among Financial Regulators

This Part presents three potential hypotheses regarding the relationship between domestic regulatory consolidation and cross-border coordination. Section I.A considers the null hypothesis—i.e., that factors exogenous to domestic regulatory structure drive international cooperation. Section I.B explores the “majority view,” which holds that the correlation between domestic consolidation and cross-border coordination is positive. Section I.C presents the alternative hypothesis—the view that this Paper ultimately endorses. I argue that domestic consolidation is negatively correlated with cross-border coordination. This Part lays out the intuitions that underlie each of these perspectives. The remainder of the Paper will test these three hypotheses against the historical record.

I.A. The Null Hypothesis: No Correlation Between Domestic Consolidation and Cross-Border Coordination

Several scholars have argued that factors exogenous to the domestic regulatory structure determine whether—and how—U.S. agencies seek to coordinate with their cross-border counterparts. According to Beth Simmons’s influential account of regulatory coordination, U.S. agencies will pursue policies through multilateral fora when the divergence between domestic and foreign regulatory regimes generates negative
externalities for U.S. markets and firms. Simmons sees regulation as a two-stage process. At the first stage, the U.S. adopts a particular policy for its capital markets, and other countries react to the U.S. policy (or the U.S. “anticipat[es] . . . the reactions of the rest of the world” when those reactions are relatively predictable). At the second stage, the U.S. determines whether other countries’ reactions have resulted in negative externalities for U.S. firms and U.S. markets. Although Simmons would acknowledge that domestic regulatory structure may have an effect on outcomes at stage one, her theory holds that domestic regulatory structure has a null effect at stage two on the decision whether to (or not to) coordinate with cross-border counterparts. From this Paper’s perspective, Simmons’s externalities argument serves as the null hypothesis because it holds that there is no correlation—positive or negative—between domestic regulatory consolidation and cross-border coordination (except inasmuch as domestic regulatory structure yields “stage one” effects).

What sorts of spillover effects from regulatory divergence might prompt the United States to pursue an international agreement? First, if other countries set bank capital requirements below the United States’, then foreign financial institutions may take

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21 Id. at 596.
22 Id. at 595-96. Similarly, Daniel Drezner proposes a “two-stage” or “two-step” framework for analyzing regulatory cooperation. “The first step is identifying the domestic actors and institutions that explain the origin of state preferences. The second step is to take those preferences as given for international interactions, and to explain the bargaining outcomes as a function of the distribution of interests and capabilities [among states].” DANIEL W. DREZNER, ALL POLITICS IS GLOBAL: EXPLAINING INTERNATIONAL REGULATORY REGIMES 6 (2007). Like Simmons, Drezner assumes a world in which the impact of domestic regulatory structure is confined to the “first step.” According to this view, any effect of domestic regulatory structure on the probability of international cooperation is indirect.
23 See Simmons, supra note 20, at 596.
on greater leverage, which increases their risk of failure. The contagion effects of a foreign firm’s failure may be felt by the firm’s U.S. counterparties (as the 1974 liquidation of Germany’s Herstatt Bank and the 1982 collapse of Italy’s Banco Ambrosiano illustrated). Second, lower capital requirements abroad may put foreign firms at a competitive advantage vis-à-vis their U.S. counterparts. For example, in the 1980s, American and European financiers argued that “Japan’s requirement for relatively low levels of capital . . . permitted its banks to offer extremely low pricing and thus capture market share.” From Professor Simmons’s perspective, the case of capital adequacy regulation supports the externalities argument: the U.S. did suffer from negative externalities, and the U.S. did respond by promoting the Basel I capital accord for commercial banks.

If Simmons’s theory is correct, then we would expect to see more multilateral regulation in industries that generate significant transnational spillover effects, and less cross-border coordination in sectors that produce smaller spillover effects. More specifically, we would expect higher levels of regulatory coordination in (1) sectors in which the failure of a single firm poses systemic risks and (2) sectors in which cross-border competition for market share is fierce.

Consistent with the first expectation, regulatory coordination has (at least historically) been much more extensive in commercial banking than in the securities and insurance industries, and the scholarly consensus (at least prior to the Lehman Brothers collapse and the near-failure of the insurer AIG in September 2008) held that the

25 See id. at 327.
26 Simmons, supra note 20, at 601-05.
systemic risks inherent in commercial banking exceed those of the latter two sectors. Before proceeding further, it is important to distinguish between solvency risk (i.e. the risk that a firm will not have sufficient assets to cover its liabilities) and liquidity risk (i.e. the risk that a firm will not have sufficient liquid assets to pay its debts as they come due). It is not necessarily the case that commercial banks face higher solvency risks than their securities and insurance industry counterparts. A 2000 study by the Federal Reserve Bank of New York\textsuperscript{27} calculated the Z-score—i.e. “the number of standard deviations below the mean by which profits must fall to bankrupt the firm”\textsuperscript{28}—for banks, securities firms, and insurers, and found that throughout the 1971-1998 period, commercial banks exhibited lower solvency risks than institutions in the other sectors.\textsuperscript{29} However, commercial banks do face unique risks to liquidity because they rely on demand deposits that can be redeemed on a “first-come, first-served” basis.\textsuperscript{30} By contrast, securities firms\textsuperscript{31} and insurance companies “are not reliant on first-come, first-served demand liabilities, and so they are (at least in theory) less vulnerable to subsequent pressures to liquidate assets rapidly in order to meet the demands of creditors.”\textsuperscript{32} The apparent fact

\textsuperscript{28} Id. at 45.
\textsuperscript{29} Id. at 46 tbl. 6.
\textsuperscript{30} Richard Herring & Til Schuermann, Capital Regulation for Position Risk in Banks, Securities Firms, and Insurance Companies, in CAPITAL ADEQUACY BEYOND BASEL: BANKING, SECURITIES, AND INSURANCE 15, 19 (Hal S. Scott ed. 2005).
\textsuperscript{31} Id. at 21.
\textsuperscript{32} Id. at 24. Herring and Schuermann conclude that securities firms generate less systemic risk than banks because (1) securities firms keep customer funds in segregated accounts, so “bad news about the firms’ own assets need not cause concern about the assets of the firms’ clients”; (2) “liabilities of the securities firms are not . . . payable on a first-come, first-served basis”; (3) “securities firms generally hold liquid, tradeable assets” that allow firms to “reduce the size of [their] balance sheet relatively easily, without incurring fire-sale losses”; and (4) “securities firms do not have direct access to large-value payment
that commercial banks are more vulnerable to “runs” than are securities firms and insurers might explain why cross-border coordination in the commercial banking sector has outpaced regulatory cooperation in other areas of financial services.

It seems strange, however, that cross-border regulatory coordination in the commercial banking sector has focused on risks to solvency, not risks to liquidity. Indeed, the Basel accords “lack . . . specified liquidity requirements” altogether.33 The Basel accords only address the asset and equity components of a bank’s balance sheet, not whether liquid assets will be available to meet liabilities as they come due. If banks pose unique systemic risks (relative to securities firms and insurers) because of the

 systems.” Id. at 21. “[T]he most important test of these hypotheses to date is the collapse of the [securities firm] Drexel Burnham Lambert“ in 1990, which caused “minimal disruption of services” and no “systemic disturbances.” Id. at 22; see also Martin F. Grace, The Insurance Industry and Systemic Risk: Evidence and Discussion 10-11 (Indiana State Univ., Network Fin. Inst. Policy Brief No. 2010-PB-02, Apr. 2010) (“Banks have deposits which are short-term in nature, but they make long-term loans. This causes a maturity mismatch . . . Insurers, in contrast, are structured differently, as their inputs and outputs are more closely matched in duration . . . [and] they do not have as severe a liquidity problem . . . .”); Scott E. Harrington, The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation 3 (Nat’l Ass’n of Mutual Ins. Cos., Issue Analysis, Sept. 2009) (concluding that “[s]ystemic risk is low in insurance markets compared with banking”); see generally George G. Kaufman, Bank Contagion: A Review of the Theory and Evidence, 8 J. FIN. SERVS. RES. 123, 125 (1994) (“[U]nlke banks, nonbanks . . . have relatively little demand or very short-term debt that can run in response to [an] adverse shock.”). But see Peter Boone & Simon Johnson, Waiting for the Next Lehman Brothers, SUNDAY TIMES (London), Sept. 13, 2009, http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article6832440.ece (noting that the securities firm Lehman Brothers held illiquid investments such as a ski resort and suburban housing developments, and “[w]orries about these investments sparked a run on the bank”); Mary Williams Walsh, Audit Faults New York Fed in A.I.G. Bailout, N.Y. TIMES, Nov, 16, 2009, at B1 (describing the downfall of insurer AIG as a “run-on-the-bank disaster”).

33 Barry Eichengreen, Ten Questions About the Subprime Crisis, 11 BANQUE DE FR. FIN. STABILITY REV. 19, 22-23 (2008); see also Charles Goodhart, Liquidity Risk Management, 11 BANQUE DE FR. FIN. STABILITY REV. 39, 40 (2008) (“[I]n the 1980s, at the same time as the Basel Committee was wrestling with capital adequacy issues, it was also attempting to reach agreement on liquidity risk management. For reasons that I have yet to discover, it failed.”).
composition of their liabilities, then one might question whether the accords actually address the negative externalities that arise from commercial banking.

Moreover, it is not clear that cross-border competition is greater in the commercial banking sector than in other industries. Commercial banking may entail higher entry barriers and switching costs than other forms of financial services, in part because banking—even in the era of the Internet—still revolves around physical branch locations.\(^{34}\) To the extent that a customer’s geographic proximity to his or her commercial bank affects the quality of services, we would expect bank customers to be less price elastic than consumers of other financial services.\(^{35}\) Indeed, U.S. commercial banks have protected their market share more effectively than many other U.S. financial services providers: whereas foreign-owned banks now account for approximately 11% of all U.S. commercial banking sector assets, foreign reinsurers control approximately 84% of the U.S. market.\(^{36}\)

\(^{34}\) See, e.g., Andrew M. Cohen & Michael J. Mazzeo, Market Structure and Competition Among Retail Depository Institutions, 89 REV. ECON. & STAT. 60, 61 (2007) (“While banking organizations have grown in size and geographic scope, there is strong evidence that retail banking markets are local in nature . . . . [C]onsumers and small businesses tend to obtain their bank services from nearby providers.”).

\(^{35}\) On entry barriers and switching costs in commercial banking, see Doris Neuberger, Industrial Organization of Banking: A Review, 5 INT’L J. OF THE ECON. OF BUS. 97 (1998); see also Claudia M. Buch, Financial Market Integration in the U.S.: Lessons for Europe 21-22 (Kiel Inst. of World Econ., Working Paper No. 1004, Sept. 2000) (“[M]arket power derived from intimate knowledge of smaller customers, of local market conditions, and from existing customer conducts has partially shielded banks from competitive pressure.”).

In sum, concerns about systemic risk and competitiveness provide—at best—an incomplete explanation for the variation in international regulatory coordination across issue areas. Even if the banking sector’s reliance on short-term deposits does lead to unique systemic risks, this does not explain why U.S. regulators have coordinated with their cross-border counterparts on bank solvency requirements but not bank liquidity requirements. Moreover, competitiveness concerns in commercial banking do not seem to be any more severe—and are perhaps less severe—than in other financial services sectors. These conclusions suggest that we cannot rely only on externalities as explanatory variables if we are to construct a coherent theory of cross-border regulatory coordination.

**I.B. The Majority View: Positive Correlation Between Domestic Consolidation and Cross-Border Coordination**

The majority view holds that the degree of domestic regulatory consolidation is positively correlated with the probability of cross-border coordination. There are two general justifications for this view. The first focuses on the capacity of regulators to reach out to their cross-border counterparts: as Professor Coffee contends, “it may be easier for a consolidated agency to . . . negotiate for ‘harmonized’ international standards than for a bifurcated structure to do so.”  

[^37]: Coffee, *supra* note 9, at 482.
fragmentation allows agencies to play a domestic “blame game” instead of addressing systemic risks through multilateral institutions.\(^\text{38}\)

There are several reasons why regulatory consolidation might affect the capacity of agencies to engage in cross-border coordination. Smaller agencies may lack the resources to conduct negotiations or joint supervisory operations with their overseas counterparts. For example, the CFTC warned Congress in 2007 that funding cuts “could require the Commission to reduce its participation in standard-setting international organizations, restrict its ability to engage in bilateral meetings with foreign regulatory authorities . . . , and restrict its ability to . . . participate in international dialogues.”\(^\text{39}\)

Meanwhile, the Office of Thrift Supervision was the agency officially tasked with the responsibility of coordinating with E.U. regulators regarding AIG,\(^\text{40}\) but OTS had no office in the U.K. (or anywhere else in Europe)\(^\text{41}\) from which to oversee the AIG London


unit that reportedly “managed $2 trillion in derivatives trades.” According to the majority view, regulatory fragmentation leads to circumstances in which a small agency may be “out of its league” in trying to supervise a complex conglomerate and coordinate with foreign officials. Consolidation would allow agencies to capitalize on economies of scale, streamlining cross-border coordination efforts through international affairs specialists.

Additionally, when more U.S. agencies have authority over a given issue area, it may be more difficult to coordinate with cross-border counterparts because the U.S. regulators have trouble coordinating even among themselves. Advocates of consolidation say that a streamlined regulatory structure will allow the United States to “speak with one voice” on international regulatory issues. However, this argument overlooks the insight from game theory that, in bargaining, the best strategy is not necessarily to present a united front. As Peter Partell writes, “domestic political structures, particularly those that constrain a leader’s ability to unilaterally make policy

44 See Singer, Subprime Accountability Deficit, supra note 7, at 27 (“Consider the immense challenges of creating a global standard . . . when the agencies within the United States are at odds with one another.”).
decisions, can . . . increase[e] a state’s ability to bargain successfully." Imagine that the Federal Reserve (which shares regulatory responsibilities over commercial banks with the Comptroller of the Currency, the FDIC, and OTS) is engaged in negotiations with the U.K.’s consolidated regulator, the Financial Services Authority. The negotiators are choosing among three policy alternatives: options A and B, both of which require U.S.-U.K. coordination, and the no-coordination status quo. Assume that the Federal Reserve prefers option A over option B and prefers option B over the status quo. Meanwhile, the FSA prefers B to A and A to the status quo. Clearly, coordination is Pareto-optimal, but it might not be immediately forthcoming. At least for a time, the Federal Reserve representative may hold out in order to achieve A, and the FSA representative may do the same in order to achieve B. If the Federal Reserve could credibly say that it would only accept A or the status quo—ruling out B altogether—then the bargaining process would immediately end, and the Fed would achieve its preferred result. The problem is that any such statement by the Fed might be viewed as “cheap talk” by the FSA. Having another U.S. agency at the table might bolster the Fed’s bargaining position by reducing the Fed’s flexibility: if the Comptroller of the Currency, the FDIC, and/or OTS vow to veto any agreement unless the agreement incorporates option A, then the FSA might see that the Fed cannot budge, in which case the bargaining process may reach a more rapid resolution (and, from the U.S. perspective, an optimal outcome). Of course, this assumes

46 Peter J. Partel, Executive Constraints and Success in International Crises, 50 POL. RES. Q. 503, 504 (1997).
that the Comptroller of the Currency, the FDIC, and/or the OTS could plausibly veto an agreement, which would only be the case when regulatory authority is fragmented.

Thus the first argument in favor of the majority view—that consolidation enhances the ability of regulators to engage in cross-border coordination—is at best questionable. The second argument in favor of the majority view—that consolidation increases the willingness of regulators to engage in cross-border coordination—is similarly suspect. According to Professor Singer, “[p]olitical pressure from Congress . . . must . . . be direct and unambiguous in order to spur regulators to press forward on the international front.”

Moreover, legislators will only hold regulators accountable when either (a) “[r]egulations that are too lax . . . contribute to faltering firms and a crisis of confidence among voters,” or (b) “regulations that are too strict . . . put domestic firms at a competitive disadvantage.” Under these conditions, legislators may remove regulatory responsibilities from an agency or, as a more drastic measure, abolish the agency entirely. When regulators cannot “maintain a balance between confidence and competitiveness” on their own, then they will “have incentives to seek an international regulatory agreement to maintain their autonomy.” However, according to Singer, “regulatory accountability in the US is muddled and fragmented,” and as a result,

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48 See Singer, Subprime Accountability Deficit, supra note 7, at 25.
49 See Singer, Capital Rules, supra note 7, at 536.
50 Id. at 540-41. For example, after the Federal Home Loan Bank Board, which regulated savings and loan associations, failed to avert an industry-wide crisis in the 1980s, Congress abolished the FHLBB and replaced it with a new agency, the Office of Thrift Supervision, lodged in the Treasury Department. See Financial Institutions Reform Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, §§ 309, 401, 103 Stat. 498 (codified at scattered sections of 12 U.S.C.).
51 Singer, Capital Rules, supra note 7 at 561.
agencies are not being held accountable in the current crisis.\textsuperscript{52} Since regulators are not being held accountable, they face no “direct and unambiguous” pressure to pursue international agreements.

There are at least two major problems with this “accountability” argument. First, although Singer assumes that Congress will respond to regulatory failures by removing responsibilities from an agency, the historical record suggests that Congress’s response might be exactly the opposite. Although an investigation by the Senate Governmental Affairs Committee after the 2001 collapse of Enron revealed a “systemic and arguably catastrophic failure” at the SEC,\textsuperscript{53} Congress responded by expanding the power of the SEC through the Sarbanes-Oxley Act of 2002.\textsuperscript{54} Similarly, despite the Federal Reserve’s regulatory failures in the run-up to the current crisis,\textsuperscript{55} the financial reform legislation passed by the Senate in May 2010 grants broad new powers to the Fed (including, potentially, the power to regulate any firm “whose size, complexity, or interconnectedness makes [it] in need of extra oversight”).\textsuperscript{56} Although there are

\textsuperscript{52} Singer, Uncertain Leadership, supra note 7, at 100.
counterexamples in which Congress has abolished an agency in response to a regulatory
failure, the correlation between crisis and autonomy is not clear-cut: regulators who fail
to “maintain a balance between confidence and competitiveness” are just as likely to gain
new powers as to lose them. Second, at least intuitively, it seems that Congress is more
likely to remove regulatory responsibilities from an agency when other already-
established agencies with overlapping mandates are available to fill the void. For
instance, it is probably easier to abolish the OTS when the Comptroller of the Currency is
already on hand to assume responsibilities for the oversight of savings and loan
associations than when OTS abolition would require a replacement agency to be built
from scratch. Thus, regulatory fragmentation might increase the pressure on an agency to
“maintain a balance between confidence and competitiveness” because fragmentation
decreases the costs that Congress would have to bear in dismantling the agency. In sum,
although Singer assumes that regulatory consolidation will lead to greater accountability,
and greater accountability will lead to greater international engagement, it may be that
regulatory consolidation reduces the likelihood that Congress will punish an agency by
withdrawing some of the agency’s regulatory powers.

I.C. The Alternative Hypothesis: Negative Correlation Between Domestic
Consolidation and Cross-Border Coordination

This Paper suggests an original, alternative hypothesis: regulatory consolidation at
the domestic level may decrease the probability of coordination at the international level.

57 The abolition of the Federal Home Loan Bank Board, see supra note 50, and the
impending abolition of the OTS, see supra text accompanying notes 2-3, are examples.
Conceptually, there are four reasons why we might expect this to be the case. First, domestic fragmentation may reduce the “autonomy costs” of cross-border coordination: if regulators are reluctant to relinquish their policymaking discretion to international institutions, then, logically, they will be more reluctant when they enjoy more discretion and less reluctant when their autonomy is already constrained. Second, domestic fragmentation may increase the “agenda control” benefits that regulators receive when they coordinate with their cross-border counterparts. An international agreement may narrow the menu of policy options at the domestic level, and a savvy regulator may use this to her advantage in order to force an up-or-down decision on her preferred policy. Third, regulators who pursue policy objectives through multilateral channels may be able to leverage the “expert legitimacy” of international institutions. The regulator may have less difficulty convincing domestic audiences to accept a particular policy once that policy has been stamped with the imprimatur of a well-respected international organization. But if regulatory authority is already consolidated such that an agency can pursue its preferred policy without obtaining the approval of domestic counterparts, then the agency may not need to leverage the legitimacy of an international institution in order to enact its regulatory agenda. Fourth, domestic fragmentation may create competitive pressures to coordinate with cross-border counterparts. Agencies may compete against their domestic rivals in a “race to coordinate”: each regulator in the fragmented system might rush to be the first to link up with cross-border counterparts.
(i) **Autonomy Costs.** Theories of regulation are often categorized as either “public interest” theories or “public choice” theories.\(^5^8\) The public interest perspective assumes that bureaucrats are “benevolent . . . , trustworthy, disinterested, and public-spirited experts who produce rules that ensure general economic efficiency and maximum welfare for society.”\(^5^9\) Public choice theory assumes that regulators are “rationally self-interested” individuals who seek to capture rents for either themselves or their benefactors.\(^6^0\) Scholars from both camps agree on the importance of “autonomy” as an interim objective for regulators. As Daniel Carpenter writes, autonomy is a “proximate goal” for all regulators because “whatever else they desire,” autonomy is “necessary to achieve it.”\(^6^1\) Professors Enrico Colombatto and Jonathan Macey, who describe themselves as followers of the “public choice” school of thought, argue that self-interest regulators covet autonomy because they seek “to maximize the rough value of their

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\(^{58}\) *See, e.g.*, Michael Hantke-Domas, *The Public Interest Theory of Regulation: Non-Existence or Misrepresentation*, 15 EURO. J.L. & ECON. 165 (2003). Hantke-Domas suggests that “public interest” theory is little more than a straw man: “Public Interest Theory does not have any known origin,” and writers who refer to it have not “mentioned any author or supporter of it.” *Id.* at 166. *But see* Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167, 168 (1990) (“A tradition starting at least with Plato, which has survived to this day, describes government policy-makers as “public individuals,” struggling to find the policy choice that is best for some polity in whose interests they govern.”).


bureaucracies.” But other scholars see a link between regulatory autonomy and the pursuit of the public interest. It may be that Federal Reserve officials genuinely believe that bank regulation will generate “general economic efficiency and maximum welfare” if it is conducted by the Fed rather than the FDIC or the Comptroller of the Currency. It may also be that SEC officials sincerely view their agency as a superior securities regulator to the CFTC or other challengers to the SEC’s incumbency. While this Paper takes no sides in the public interest/public choice debate, I will assume that regardless of whether regulators behave in their own interests or in the interests of society at large, they will value autonomy as a means for achieving whatever end they adopt.

Thus, public interest and public choice theorists alike can agree with Professors Colombatto and Macey when they write that “[a]ll else equal, regulators would prefer not to cede or to share authority with their counterparts from other countries.” When regulators reach agreements with their cross-border counterparts, they incur “

62 Colombatto & Macey, supra note 60, at 933 (citation omitted); see also JAMES Q. WILSON, BUREAUCRATS: WHAT GOVERNMENT AGENCIES DO AND WHY THEY DO IT 195 (1988) (presenting a public choice perspective) (“Autonomy is valued [by agencies] at least as much as resources, because autonomy determines the degree to which it is costly to acquire and use resources.”).

63 See Frances E. Rourke, Bureaucratic Autonomy and the Public Interest, 22 AM. BEHAV. SCI. 545 (1979) (“As far as self-directing agencies are concerned, it can be argued that the autonomy they enjoy is often indispensable for the effective performance of a public function.”).


65 See, e.g., David L. Ratner, The SEC at Sixty: A Reply to Professor Macey, 16 CARDozo L. REV. 1765, 1772 (1994) (“outside observers rate the SEC as a far more effective regulator than the CFTC in dealing with essentially similar problems”).

66 Colombatto & Macey, supra note 60, at 926.
costs” because they bind themselves to pursue certain policies and promise not to pursue others. Moreover, the autonomy costs of cross-border regulation will be higher when a regulator’s baseline level of policymaking autonomy is higher. Cross-border coordination will be less attractive to a regulator in a consolidated system who enjoys wide policymaking discretion at the domestic level, while a regulator whose discretion is already quite constrained will see that she has less to lose if she binds herself to an international accord.

(ii) Agenda Control. Not only may cross-border coordination lead to lower costs for a regulator in a fragmented environment, but it also may bring greater benefits. Specifically, international agreements may serve as tools for agenda control. Imagine three regulators (1, 2, and 3) who choose among three policy options (A, B, and C). Regulator 1 prefers A to B and B to C. Regulator 2’s preference order is B, then C, then A. Regulator 3’s preference order is C, then A, then B. All regulators prefer A, B, and C to the status quo, but no single policy option generates a consensus (or even a majority). The consequence is a voting “cycle”: “policy proposals can just go around and around with no end.” The cycle will only end if one actor delimits the menu of options.

International institutions can enable domestic actors to assert control over the policy agenda by forcing a choice between two options. For example, Regulator 2 and her cross-border counterparts may sign an agreement adopting option B. This forces

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Regulators 1 and 3 to choose between ratification or rejection of the accord (B versus the status quo). By excluding options A and C from the policy menu, Regulator 2 can achieve her ideal outcome. Part II of this Paper shows how the Federal Reserve used a similar strategy to cut through regulatory gridlock at several points in the late 1980s.

(iii) Importing Credibility. International organizations—especially those with long histories and large professional staffs—acquire “expert legitimacy” on the basis of their technical capabilities and reputation for competence. International organizations can “wrap…a cloak of scientific respectability” around a regulator’s policy proposals.71 This “cloak of scientific respectability” may make the regulator’s arguments more compelling in the eyes of domestic audiences. When financial governance is framed in technical rather than political terms, professional economists employed by international organizations can lend legitimacy to domestic regulators by bolstering the impression that rules reflect cutting-edge expert knowledge.72 Thus, regulators may be willing to incur some autonomy costs in order to acquire this “cloak.” However, the cloak will only be necessary to a regulator who cannot adopt domestic policies on its own—i.e., a regulator who needs to build a coalition of political actors in order to achieve its policy preference. In other words, the cloak only has value to a regulator in a fragmented system whose policymaking discretion is constrained by domestic rivals. Indeed, for the Federal Reserve, the cloak of legitimacy conferred by an international organization did come in handy when the Fed was otherwise constrained by domestic regulatory rivals. Just as the Federal Reserve used the Basel Committee for agenda control purposes in the 1980s, the

72 *Id.* (citation omitted).
Fed also leveraged the expert legitimacy of the Basel Committee in order to justify its “value-at-risk” approach to capital regulation in the early 2000s. Section II.C will explore this episode in further detail.

**iv) Competitive Coordination.** Finally, a regulator may pursue cross-border coordination (at least in part) to preempt another agency from doing the same. In this respect, cross-border coordination may result from a sort of prisoner’s dilemma among agencies: no agency wants to bear the autonomy costs of multilateralism, but each regulator would prefer to be bound by an agreement that it negotiated rather than an agreement that one of its domestic rivals negotiated. The “race to coordinate” may also serve to expedite the often-laborious process of negotiating an international agreement.

Part III of this Paper show how “first to coordinate” pressures drove the SEC toward an agreement with the U.K. Financial Services Authority in 2004 on capital requirements for securities firms.

Ultimately, the viability of the hypotheses presented in this Part depends on whether they successfully predict real-world outcomes. The challenge is not only to explain cross-border coordination when it occurs, but also to account for the “dogs that didn’t bark.” Indeed, any effort to identify the determinants of cross-border coordination that only focused on cases of cross-border coordination would be “selecting on the dependent variable” and would thus be of limited inferential value. Accordingly, the following Parts will examine the three traditional financial services sectors—banking,

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securities, and insurance—even though cross-border coordination has not arisen in all three. By considering cases in which the value of the dependent variable is positive (i.e. cross-border coordination does occur) and cases in which the value of the dependent variable is negative (i.e. it does not), this Paper seeks to provide a fuller account of the relationship between domestic regulatory consolidation and international outcomes.

II. Case Study: Capital Requirements, Liquidity Requirements, and Holding Company Rules in the Banking Sector

A. The Basel I Accords

In July 1988, regulators from a dozen industrialized economies gathered in Basel, Switzerland, to sign an agreement imposing common capital standards on banks within their jurisdictions. The so-called Basel I accord adopted a “risk bucket” approach to capital requirements. As a general rule, banks would have to hold $4 in equity or equity-like “Tier 1” capital for every $100 in “risk-weighted” assets. But not all assets were weighted the same. For example, OECD government debt would carry a 0% risk weight (and thus banks would not have to carry any capital to offset OECD debt on their balance sheets). Residential mortgages would carry a 50% risk weight (and thus banks would have to carry $2 in Tier 1 capital for every $100 in home loans on their balance sheets). Loans to corporations would carry a 100% risk weight.75 Twelve industrialized countries

agreed to impose this common regulatory scheme on their banks, with the requirements taking effect by 1992.76

At the time, bank regulators expressed hopes that their colleagues in the securities and insurance sectors would coordinate capital standards for firms in their industries as well.77 Yet more than one-and-a-half decades would elapse before U.S. and E.U. regulators would establish a common system for regulating capital at securities firms, and there is still no Basel-style accord for insurance. What explains the coordination of capital standards in banking and the lack of coordination in adjacent sectors? Part II begins to answer this question by examining the factors that motivated the Federal Reserve to pursue (some of) its policy objectives through international channels.

Standard accounts of the Basel I accord emphasize two motivations for the 1988 agreement. First, regulators recognized that undercapitalized banks generated “systemic risks”: the failure of a bank in one country could have spillover effects on financial markets in another.78 Second, U.S. and U.K. regulators sought to achieve a “level playing field”79 for their banks vis-à-vis Japanese competitors. Before Basel, Japanese banks carried less capital than their U.S. counterparts, which presumably tilted the field in the

76 The twelve signatories were Belgium, Canada, France, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States and West Germany. See generally Nathaniel C. Nash, Agreement on Banks’ Capital Set, N.Y. TIMES, July 12, 1988, available at http://www.nytimes.com/1988/07/12/business/agreement-on-banks-capital-set.html?pagewanted=all (summarizing the elements of the accord).
78 See Kapstein, supra note 24; Simmons, supra note 20, at 601-02.
79 Kapstein, supra note 24, at 339. Kapstein notes, however, that Basel I, “while theoretically leveling the playing field between the international commercial banks, will now tip the field in favor of nonbank financial institutions.” Id. at 345.
Japanese banks’ favor and enabled them to capture an ever-larger share of the U.S. market.

The problem with the first explanation is that it fails to explain why the accord set common capital requirements but not common liquidity requirements, given that the latter may be even more significant to systemic stability. The problem with the second explanation is that Basel I did not level the playing field between Japanese and U.S. banks, and—if anything—it tilted the field even further toward the Japanese banks’ advantage. Japan’s high domestic savings rate meant that the cost of equity for Japanese banks was much lower than the cost of equity for American ones.\(^80\) Although Basel I would require Japanese banks to raise more equity than American banks, the total cost of complying with Basel I (i.e. the cost of raising equity times the amount of equity that had to be raised) would actually be higher for U.S. institutions than for their Japanese competitors.\(^81\)

Yet the Federal Reserve officials did press for a global bank capital standard, despite evidence that the “level playing field” argument was illusory.\(^82\) What explains the U.S. central bank’s persistent promotion of global capital standards? The majority view

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\(^81\) By one estimate, Japanese banks needed to raise $70 billion to meet the Basel requirements, whereas US banks needed to raise $30 billion. See John Evans, Japanese Banks Raised $50 Billion in Capital Over 2 Years, Official Says, AM. BANKER, July, 1989, at 1. If these and the BIS cost-of-equity figures are accurate, see supra note 80, then the annual cost of Basel compliance for the Japanese banking industry was $2.2 billion, compared to $3.6 billion for the US banking industry.

\(^82\) On the “decisive leadership” of the Federal Reserve and the Bank of England in the Basel I process, see Kapstein, supra note 24, at 324.
and the alternative hypothesis outlined in Part I turn our attention inward—toward
domestic regulatory structure. The Fed faced severe constraints on its domestic autonomy
over commercial bank capital regulation. Consistent with the alternative hypothesis
presented in Part I, the Fed used an international institution—the Basel Committee—as a
means of gaining control over the domestic regulatory agenda.

Regulatory authority over commercial banks in the U.S. is severely fractured. The
Federal Reserve is the primary regulator for only one-tenth of U.S. depository
institutions. A separate agency, the Federal Deposit Insurance Corp. (FDIC), is the
primary national-level regulator for more than three-fifths of individual banks. However,
most of the largest banks come under the supervision of the Treasury Department’s
Office of the Comptroller of the Currency (OCC), so the OCC ultimately supervises 61%
of all bank assets.\(^83\) Whether we measure by the number of institutions or the percentage
of assets, the vast majority of the U.S. banking system lies beyond the Fed’s immediate
regulatory reach.\(^84\)

\(^{83}\) See FDIC, *The FDIC and the Banking Industry: Perspective and Outlook, in 2008-
2013 Strategic Plan (2008), available at*
http://www.fdic.gov/about/strategic/strategic/bankingindustry.html (based on data from
the third quarter of 2008). The fourth federal bank regulator, the Treasury Department’s
Office of Thrift Supervision, was not founded until 1989 and thus played no role in the
negotiation of the 1988 Basel I accord.
Table I: Institutions and Assets Supervised By U.S. Bank Regulatory Agencies  
(2008 FDIC data)

<table>
<thead>
<tr>
<th>Supervisor</th>
<th>Number (%) of Institutions Supervised</th>
<th>Assets (%) of Institutions Supervised (dollars in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FDIC</td>
<td>5134 (61%)</td>
<td>$2,217,547 (16%)</td>
</tr>
<tr>
<td>Comptroller of the Currency</td>
<td>1556 (19%)</td>
<td>$8,334,895 (61%)</td>
</tr>
<tr>
<td>Federal Reserve</td>
<td>875 (10%)</td>
<td>$1,803,611 (13%)</td>
</tr>
<tr>
<td>Office of Thrift Supervision</td>
<td>819 (10%)</td>
<td>$1,217,637 (9%)</td>
</tr>
<tr>
<td>Total</td>
<td>8384</td>
<td>$13,573,691*</td>
</tr>
</tbody>
</table>

*Dollar amounts and percentages do not sum to total due to rounding. 
Source: FDIC, supra note 83.

After the collapse of Continental Illinois National Bank in 1984—the largest failure of a U.S. depository institution up to that time—federal regulators from all the agencies agreed that something needed to be done to shore up bank balance sheets. The biggest US banks had made large loans to Latin American governments, and those loans now appeared to be on the verge of default. However, each regulator had a different policy preference.

In 1985, the regulators agreed that all banks would have to hold capital equal to 6% of assets. But this was not a stand-alone solution because it did not block banks from shifting away from safe investments (e.g. Treasury bonds) to riskier ones (e.g.

86 James Kraus, New Maneuvers in ’87 Curbed Banks’ Loan Exposure, AM. BANKER, Jan. 18, 1988, at 2.
commercial loans and third-world debt). To counter this threat, the Fed, under Chair Paul Volcker, sought to impose a “risk bucket” approach—i.e., one that would require banks to carry more equity if they held riskier assets on their balance sheets. Volcker hoped that this approach would encourage banks to adopt prudent policies.

However, Volcker faced resistance on four fronts. First, the powerful American Bankers Association opposed the plan because higher capital costs would cut into member-banks’ earnings. Second, Reagan Administration officials opposed the plan because, unlike Volcker, they wanted to link capital requirements to the diversification of banks’ balance sheets (which would likely advantage the nation’s largest financial institutions). Third, the Fed’s own seven-member Board of Governors was not unanimous in its support of the plan. Governor Martha Seger said the proposal “gives me nightmares” because it would get federal authorities involved in banks’ credit allocation decisions. Fourth, and most importantly, the Federal Reserve did not have the approval of its fellow regulators, who effectively exercised veto power over bank capital rules because they controlled large swaths of the banking sector beyond the Fed’s regulatory reach.

FDIC Chair William Seidman was among the Volcker plan’s most vocal critics. The FDIC already had its own system to assess bank risk, the so-called CAMELS rating.

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88 Nina Easton, Big Banks to Feel Brunt of Risk-Based Capital Plan, AM. BANKER, Jan. 16, 1986, at 1.
91 The letters of CAMELS stand for the six components of each bank’s rating: Capital adequacy; Asset quality; Management; Earnings; Liquidity; and Sensitivity to market
scheme. Like the Volcker plan, CAMELS accounted for the size of a bank’s capital cushion and the riskiness of its assets, but CAMELS also allowed FDIC supervisors to evaluate management quality, earnings streams, and liquidity.\textsuperscript{92} FDIC officials believed that CAMELS offered a better measure of bank stability than the Volcker plan provided. Moreover, as the agency that supervised the largest number of U.S. banks, the FDIC would bear the lion’s share of the implementation costs under the Volcker plan, and FDIC officials expressed concerns about their “potential record-keeping burden” under Volcker’s proposal.\textsuperscript{93}

Instead of risk-based capital requirements, the FDIC wanted to see risk-based deposit insurance premiums. Previously, the FDIC had levied an 0.08% charge on all bank deposits to finance its insurance fund. Now, the FDIC wanted to impose higher rates on banks with worse CAMEL ratings. Unlike the Fed’s capital proposal, the FDIC’s premium proposal gained broad support from bankers.\textsuperscript{94} The chairman of the Senate Banking Committee also backed the FDIC idea.\textsuperscript{95} However, Volcker feared that the


\textsuperscript{94} The FDIC released a survey at the time showing that 80% of bankers supported its risk-based premium plan. Bart Fraust, \textit{Seidman Opposes Volcker on Risk Plan}, \textit{Am. Banker}, Nov. 21, 1985, at 1.

\textsuperscript{95} Bartlett Naylor, \textit{Volcker to Propose Risk-Based Capital Rule}, \textit{Am. Banker}, Sept. 12, 1985, at 1.
FDIC’s plan would drain funds from the weakest banks—i.e., the very banks that most needed to bolster their capital bases.96

The Office of the Comptroller of the Currency, meanwhile, took the middle ground in the Fed-versus-FDIC debate. The OCC supported risk-based capital requirements and risk-based deposit insurance.97 Testifying to Congress in 1985, Deputy Comptroller Michael Patriarca said that his office would choose risk-based capital standards above risk-based deposit insurance if it had to choose between the two, but Patriarca emphasized that the Seidman and Volcker plans were not mutually exclusive.98

The Fed had two advantages over its domestic regulatory rivals. First, Fed officials had been meeting since 1974 with other central bankers to discuss regulatory issues at the Bank for International Settlements headquarters in Basel, Switzerland. Initially, the Basel Committee was a club exclusively composed of central bankers. The Comptroller was admitted in the late 1970s,99 but central banker dominance at Basel continues. Every committee chairman since 1974 has been a central banker. And the Federal Reserve holds two seats on the committee, whereas other U.S. agencies have only

97 See Naylor, supra note 95.
one. Second, the Fed’s proposal was the only one that was compatible with other industrialized economies. Germany, Switzerland, and the U.K. already had risk-based requirements, but more than half of the Basel members did not have permanent deposit insurance funds. Even if the other Basel members had wanted to implement the Seidman plan, they would not have had the national-level infrastructure to do so.

In short, the Fed’s unique position on the Basel Committee allowed Volcker to use cross-border coordination to his domestic advantage. In early 1984, Volcker put the capital adequacy issue on the Basel Committee agenda, although negotiations moved slowly until July 1986. In that month, Volcker approached Bank of England Governor Robin Leigh-Pemberton and suggested that the central banks bilaterally compose an Anglo-American plan. These talks led to an agreement between the Fed and the Bank of England in January 1987 that mirrored Volcker’s earlier proposals. The U.S. and U.K. central bankers then worked “to get other countries on board as soon as possible.”

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In order to convince Japan to comply, the U.S. and U.K. had to make huge concessions that undid any “level playing field” benefits of the accord. For example, they allowed Japanese banks to virtually all their expected after-tax securities gains toward the Basel requirements. According to a Standard & Poor’s report, this meant that Japanese banks would meet the Basel thresholds easily “unless the [Tokyo] stock market drops substantially.” Indeed, Tokyo’s Nikkei 225 index did tumble 39% in 1990, and still, “[d]espite the sharp decline in Japanese stock prices, none of the banks experienced problems meeting the new capital requirement” once the Basel accord went into effect.

Whatever the factors behind the Basel I accord, it is difficult to argue that the Fed’s driving motive was to help U.S. banks compete against their Japanese competitors, as the accord itself did nothing of the sort.

The Basel Committee agreed to a draft agreement in December 1987 and a final accord the following July. Although the accord did not level the playing field internationally, it did tilt the balance domestically in favor of the Fed’s preferred policy. With an international consensus supporting risk-based capital standards, the FDIC acquiesced to the new requirements. As one U.S. negotiator recalls: “Everyone at the end

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of the day had to agree to it, even though the FDIC didn’t particularly believe in it.”

By shifting negotiations from the domestic to the international level, the Fed had put the risk-based capital question at the top of the agenda. Faced with an either-or choice between risk-based capital standards or the status quo, the Comptroller—and even, ultimately, the FDIC—acquiesced to the Fed’s preferred policy.

**B. Beyond Basel: Two Dogs That Didn’t Bark . . . And One That Did**

The Fed’s internationalist approach to bank capital requirements contrasts with its go-it-alone approach to liquidity standards. In order to ensure that banks have sufficient liquid assets to sudden withdrawal demands, regulators require banks to keep a minimum amount of cash on hand. At the time of the Basel accord, the reserve requirement in the U.S. for transaction deposits was 12%; among major industrialized nations, only West Germany imposed higher reserve requirements than the U.S. (see Table 2). The U.S. was also one of only two Basel committee members (West Germany being the other) that did not allow banks to earn interest on their reserves. Thus U.S. banks incurred an opportunity cost equivalent to the interest rate that they would have received if they had lent funds instead of holding them in reserve.

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Table 2: Legal Reserve Requirements, 1989

<table>
<thead>
<tr>
<th>Country</th>
<th>Transaction Deposits</th>
<th>Term Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>10%</td>
<td>3%</td>
</tr>
<tr>
<td>France</td>
<td>5.5%</td>
<td>3%</td>
</tr>
<tr>
<td>Germany</td>
<td>12.1%</td>
<td>4.95%</td>
</tr>
<tr>
<td>Japan</td>
<td>1.75%</td>
<td>1.2%</td>
</tr>
<tr>
<td>UK</td>
<td>0.45%</td>
<td>0.45%</td>
</tr>
<tr>
<td>US</td>
<td>12%</td>
<td>3%</td>
</tr>
</tbody>
</table>

If regulators pursue cross-border coordination in response to negative externalities, then one might have expected to see the Fed push for common liquidity requirements. As mentioned above, banks pose unique liquidity risks, but not necessarily unique solvency risks. Moreover, as a 1999 World Bank study showed, differential liquidity requirements cause more significant cross-national gaps in bank profitability than differential capital levels do. And if regulatory consolidation is positively correlated with cross-border coordination, then the likelihood of a global liquidity agreement would be especially high: the Fed’s Board of Governors “has sole authority over changes in reserve requirements” for U.S. depository institutions. However, the autonomy costs for the Fed in agreeing to an international liquidity accord are high: it

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114 See supra text accompanying notes 27-33.
already enjoys free rein on this matter. Moreover, since the Fed already controls the domestic agenda regarding reserve requirements, it has no need for international institutional assistance in delimiting the policy menu.\footnote{The Fed briefly raised the issue of reserve requirement harmonization at the BIS in the late 1970s, but it had dropped its harmonization efforts by the early 1980s. \textit{See} Tobin, \textit{supra} note 99, at 180-82.} Thus, although the “missing case” of global liquidity standards conflicts with the externalities hypothesis and the “majority view” that consolidation and coordination go hand-in-hand, it remains consistent with this Paper’s alternative hypothesis of a negative correlation between domestic consolidation and cross-border coordination.

The case of bank holding company (BHC) capital adequacy poses a similar puzzle. The Basel I accord imposed capital requirements on commercial banks but not on the holding companies that own them\footnote{See Bill Orr, \textit{The Fed Drops the Other Shoe}, ABA BANKING J., Oct. 1988, at 124.}. For example, Japan’s Mitsubishi Group (which owns a carmaker, an oil company, and a plastics manufacturer in addition to Japan’s largest financial institution) would not face group-wide regulations under Basel; the accord only applied to the group’s banking business. However, the Fed announced in August 1988 that it would apply the Basel requirements to U.S. BHCs as well as their commercial bank subsidiaries.\footnote{See David Vesey, \textit{Fed Passes New Capital Requirement for Banks}, UNITED PRESS INT’L, Aug. 3, 1988.} Why, after a two-and-a-half-year process of negotiating a “common international standard” for commercial banks, would the Fed act unilaterally on BHC capital?
Since 1956, the Fed has been the primary regulator of BHCs under U.S. law—even if the holding company’s subsidiary units are supervised by other agencies.\textsuperscript{120} As in the case of reserve ratios, this is an instance in which regulatory authority in the U.S. is consolidated. Although in the summer of 1988, as the Fed prepared to implement its BHC rules, news reports mentioned “growing concern at the F.D.I.C. and the Office of the Comptroller of the Currency that the Fed’s proposal will . . . place the nation’s banking organizations at a disadvantage against their international competitors,”\textsuperscript{121} the Fed was able to forge ahead with its plan because its regulatory authority over BHCs is uncontested. Consistent with the alternative hypothesis—but inconsistent with the majority view—the Fed adopted a go-it-alone approach to holding company rules rather than coordinating with its cross-border counterparts.

In the mid-1990s, however, the Fed found itself facing constraints from rival domestic regulators once again. In 1996, Fed Chair Alan Greenspan remarked that “the marketplace has become much more complicated in ways that risk-based rules cannot handle.” He said he was “impressed” by the “value at risk” (VaR) models that large commercial banks had developed for internal risk management purposes, and he directed Fed staff members to study these models to determine whether they could be used as regulatory tools.\textsuperscript{122} Greenspan’s ideas gained currency overseas: the head of banking

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\textsuperscript{121} See Nathaniel C. Nash, Capital Plan Feared As a Burden on Banks, N.Y. TIMES, July 15, 1988, at D1.
\textsuperscript{122} See Alan Greenspan, What Should Regulators Do?, 78 J. OF LENDING & CREDIT RISK MGMT. 14 (1996). The “value at risk” is the amount of money that banks are at risk of losing on their loan portfolio or trading book. Theoretically, a bank should hold capital equal to or greater than that value so that shareholders – not depositors – will bear the costs of a large loss. Id.
\end{flushright}
supervision at the Bank of England, Michael Foot, said in 1997 that banks’ internal
models could become the basis for capital requirements “in five [or] 10 years.”123 But the
VaR approach did not garner support from other U.S. bank regulators. In a December
1997 speech, Comptroller of the Currency Eugene Ludwig expressed “misgivings about
letting financial institutions in effect set their own capital levels.”124 A May 1999 FDIC
report pointed to “serious deficiencies in the proposals that regulators use banks’ own
internal risk-management models in setting capital requirements.”125

In 2001, the Basel Committee released a revised capital adequacy framework that
endorsed the VaR approach for internationally active banks. The Comptroller and the
FDIC, having failed to block “Basel II” at the international level, sought to stop its
implementation domestically. The Fed, Comptroller, and FDIC all appealed to Congress
for support. Fed officials sought to leverage the expert legitimacy of the Basel
Committee. For example, Fed Vice Chairman Roger Ferguson assured a House
subcommittee in February 2003 that the VaR approach “builds on the best practices in
risk management in banking over the past decade,” citing the Basel Committee’s explicit
endorsement.126 Moreover, the Basel II accord changed the context of interagency
bargaining within the US. What had been a three-way fight among domestic regulators

123 See George Graham, Bankers’ Weight Loss, FIN. TIMES, Apr. 4, 1997 (quoting Foot).
Examination Council Conference on Regulatory Capital (Dec. 12, 1997), available at
125 Daniel A. Nuxoll, Internal Risk-Management Models as a Basis for Capital
Requirements, 12 FDIC BANKING REVIEW 18, 27 (1999).
126 Basel II and H.R. 2043: Hearing Before the Subcomm. on Capital Markets, Ins., and
Gov’t Sponsored Enters. of the H. Comm. on Fin. Servs., 107th Cong. (2003) (statement
of Roger W. Ferguson, Jr., Vice Chairman, Fed. Reserve Bd.), available at
(or a four-way fight, if the OTS is included)\textsuperscript{127} now looked like a quixotic attempt by the FDIC and the Comptroller to roll back the advance of cutting-edge risk-management techniques that were being implemented in other countries. Ultimately, under pressure from other Basel Committee nations as well as U.S. lawmakers, the FDIC and OCC signed off on the domestic implementation of the Basel II accord in 2007.\textsuperscript{128} As per the FDIC’s insistence, the US retained elements of the risk-unweighted system that had existed alongside the Basel I rules.\textsuperscript{129} But in the end, the Fed achieved its principal objective: switching the largest US banks away from Basel I’s “risk-bucket” approach and toward a more sophisticated VaR system.

To recap: the Fed has used international institutions to achieve its preferred policies in the capital adequacy issue area, where its autonomy is limited, but it has not relied on international institutions in areas (specifically, reserve requirements and holding company rules) in which its mandate is wide. When—and only when—the Fed faces domestic constraints, it utilizes international institutions to legitimize its own policies and to control the domestic agenda. Consistent with the alternative hypothesis presented in Part I, the Federal Reserve turns to cross-border coordination only on issues over which it does not enjoy consolidated control at the domestic level.


III. Case Study: Capital Requirements in the Securities Sector

Whereas the Fed has limited autonomy to set capital requirements for US commercial banks, the SEC has had sole authority to set capital requirements for registered broker-dealers that trade stocks and bonds on national exchanges since the 1930s.\(^{130}\) However, this autonomy came under threat from two sides in the last quarter-century. First, securities firms sought to evade SEC capital requirements by establishing non-broker-dealer subsidiaries that would engage in off-exchange transactions (e.g. over-the-counter derivatives deals). This was because the SEC imposed capital requirements for derivatives deals that were so high that “no firm can afford to write such contracts within the SEC-registered broker.”\(^{131}\) Second, the Fed sought to tear down the so-called “firewall” between bank holding companies (BHCs) and securities firms. The 1933 Glass-Steagall Act prohibited BHCs from affiliating with any entity that is “engaged principally” in the underwriting or distribution of stocks and bonds. The Fed chipped away at the Glass-Steagall firewall throughout the 1980s and early 1990s,\(^{132}\) and the coup

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A decade before the repeal of Glass-Steagall, the U.K.’s top stock market regulator, the Securities and Investments Board (SIB), launched a push for global capital adequacy standards for securities firms. (The SIB would change its name to the Financial Services Authority in 1997, and in 2000, it gained responsibility for regulating banks and insurers as well). The International Organization of Securities Commissions (IOSCO) was the locus of the SIB’s efforts. At the time, the President of the Federal Reserve Bank of New York, Gerald Corrigan, gave his endorsement to the SIB/IOSCO proposal,\footnote{See Regulators Propose Minimum Capital Rules For Securities Industry, \textit{THOMSON’S INT’L BANKING REGULATOR}, Feb. 10, 1992, at 1.} and CFTC Chairwoman Wendy Gramm suggested that her agency would support the plan as well,\footnote{See Aaron Pressman, \textit{CFTC Officials May Oppose SEC on Capital Standards Issue, INVESTMENT DEALERS’ DIGEST}, Nov. 23, 1992, at 6.} but SEC Chair Richard Breeden rejected the SIB/IOSCO standards, calling them “imprudent in the extreme.”\footnote{Securities Regulation: Capital Spat, \textit{ECONOMIST}, Oct. 31, 1992, at 76 (quoting Breeden).} In February 1993, Breeden skipped the IOSCO session in Trinidad at which regulators had hoped to hash out a capital adequacy agreement.\footnote{John M. Doyle, \textit{SEC Chief By-Passes International Regulators’ Meeting}, \textit{ASSOC. PRESS}, Feb. 10, 1993.} IOSCO officially ended its effort to negotiate a common capital standard that year.\footnote{DAVID ANDREW SINGER, \textit{REGULATING CAPITAL: SETTING STANDARDS FOR THE INTERNATIONAL FINANCIAL SYSTEM} 93 (2007).}

Meanwhile, on the domestic front, the Gramm-Leach-Bliley Act further fragmented the regulatory structure for U.S. securities firms. Specifically, it allowed securities firms to transform themselves into bank holding companies (BHCs), which
would let them borrow directly from the Fed and achieve a more secure source of liquidity.\textsuperscript{139} If a securities firm selected the BHC option, then the Fed—not the SEC—would become its consolidated supervisor. Meanwhile, the Office of Thrift Supervision interpreted the Gramm-Leach-Bliley Act as allowing it to exercise supervisory authority over three major securities firms, Lehman Brothers, Merrill Lynch, and Morgan Stanley, which owned small savings-and-loan associations.\textsuperscript{140} Securities firms also had the option to choose the SEC as their consolidated supervisor (in which case the Commission would oversee the entire company, not just its broker-dealer unit) or the option to stick with the status quo, in which the SEC only oversaw broker-dealer operations.\textsuperscript{141} Initially, all the major investment banks selected this latter option.

Further complicating matters, the EU passed a Financial Conglomerates Directive in 2002 that required non-EU firms to find a national regulator within the EU who would verify that the firm’s home-country regulator provided “consolidated supervision” that

\textsuperscript{139} The securities firms Morgan Stanley and Goldman Sachs exercised this option in September 2008.


was “equivalent” to EU requirements. If the firm and its U.S. regulator failed to gain equivalence recognition, the firm would have to comply with EU requirements directly, starting in 2005.\footnote{Financial Conglomerates Directive (Directive 2002/87/EC of the European Parliament and of the Council) (Dec. 16, 2002).} The Fed already exercised consolidated supervisory authority over bank holding companies, and Fed Governor Susan Bies testified to a House committee in May 2004 that the Fed “fully expect[s] that U.S. banking organizations will be found to meet the supervision standard of the directive.”\footnote{U.S.-EU Regulatory Dialogue: Hearing Before the H. Comm. on Fin. Serv. 108th Cong. (2004) (statement of Susan Bies, Governor, Fed. Reserve Bd.), available at http://www.federalreserve.gov/boarddocs/testimony/2004/20040513/default.htm.} But other agencies scrambled to obtain “equivalence” recognition from their European counterparts. The SEC opened talks with the U.K. FSA, as London was site of the European head offices for the largest U.S. securities firms.\footnote{The SEC was also aware that Ireland could potentially assert that it was the competent authority to grant equivalence recognitions for some US securities firms—in particular, Merrill Lynch—that had been shifting operations from London to Dublin. Telephone Interview with Annette Nazareth, Former SEC Comm’r (Jan. 7, 2009).} The OTS approached the FSA\footnote{According to then-OTS Director James Gilleran, the FSA in fact reviewed the OTS’s regulatory requirements and found them to be “equivalent.” E-mail from James Gilleran to Author (Feb. 19, 2009, 22:03 EST) (on file with author).} as well as France’s Commission Bancaire (which would ultimately recognize the OTS as an “equivalent” supervisor for the ill-fated insurance giant AIG).\footnote{Press Release, Office of Thrift Supervision, OTS Receives EU Equivalency Designation for Supervision of AIG (Feb. 22, 2007), available at http://www.ots.treas.gov/)%5C?p=PressReleases&ContentRecord_id=df05bfa2-8364-45a7-bf4e-18437165c11f.}

Competitive pressure from the Fed and the OTS meant that if the SEC did not coordinate with its EU counterparts, another U.S. agency might gain EU authorization to serve as the “equivalent” supervisor for the largest U.S. investment banks. Accordingly, the SEC moved to establish a new “Consolidated Supervised Entity” program that would
set capital requirements on a holding-company-wide basis for firms that opted into the arrangement. Five firms—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—did so. The U.K. FSA recognized the CSE arrangement as “equivalent” to its own supervision—thus allowing the five firms to operate in the EU after the Financial Conglomerates Directive took effect in 2005. As an added (and possibly “unnecessary”\textsuperscript{147}) inducement to lure the firms into the CSE program, the SEC allowed firms in the CSE program to calculate their capital requirements on a VaR basis (consistent with Basel II) instead of abiding by longstanding broker-dealer capital rules.\textsuperscript{148}

Because of this last provision, the CSE program acquired a measure of infamy after the five firms either went bankrupt or required government bailouts in 2008.\textsuperscript{149} In September 2008, SEC Chairman Christopher Cox announced that the commission had discontinued the program (at which point all five firms had either ceased to exist as independent entities or already applied to the Fed for bank holding company status). Cox acknowledged that the CSE program “was fundamentally flawed from the beginning, because investment banks could opt in or out of supervision voluntarily.”\textsuperscript{150}


Arguably, this criticism is unfair. The CSE program marked the first time that the SEC gained standard-setting authority over broker-dealers’ holding companies—a power that the SEC had sought “for years.” 151 Absent the CSE program, the SEC would have had authority to set capital levels only for investment banks’ broker-dealer units, and the SEC would have had limited ability to address risks emerging elsewhere in the firms’ portfolios. Moreover, the SEC’s CSE program should be evaluated against the alternatives—which included OTS supervision for securities firms. OTS Director James Gilleran famously appeared at a 2003 press conference with a chainsaw to show that he would cut regulatory requirements for financial institutions. 152 To fund its operations, the OTS “depends on fees paid by banks it regulates and competes with other regulators to land the largest financial firms.” 153 The OTS’s own consolidated supervision program did not have any specific quantitative capital requirements for holding companies. 154 In this respect, the CSE program can be seen as having prevented the OTS from gaining regulatory responsibility over several large investment banks—a fate that might have made the financial crisis even worse.

The relevant question for this Paper, however, is not whether the SEC should have acted differently in establishing the CSE program in 2004, but why it acted as it did.

151 See Telephone Interview with Annette Nazareth, supra note 144.
154 E-mail from James Gilleran, Former Dir., OTS, to Author (Feb. 20, 2009, 13:12 EST) (on file with author).
More specifically, why did it stymie cross-border coordination at the beginning in 1990s and spearhead such efforts in the early 2000s?

The “externalities” argument offers little insight. The securities industry was already quite globalized in the early 1990s, so fears about systemic risk and a “level playing field” do little to explain the SEC’s shift. Moreover, the “externalities” argument assumes that all regulators respond to negative externalities in the same way. Why did the Fed and the CFTC—but not the SEC—support the SIB/IOSCO plan in the early 1990s?

The concept of “autonomy costs” offers a possible answer. The Fed and CFTC had little to lose by binding themselves to global capital adequacy standards for securities firms because they did not have authority over securities firms at the domestic level. In the early 1990s, autonomy costs for the SEC were much higher because the SEC would be ceding control over an issue area that lay within its discretion.

Moreover, the SEC’s switch from anti- to pro-coordination contradicts the majority view regarding regulatory consolidation. The Gramm-Leach-Bliley Act further fragmented regulatory authority by enabling the Fed and OTS to wield supervisory powers over securities firms. And yet it was only after Gramm-Leach-Bliley that the SEC sprung into action.

The SEC’s successful efforts to negotiate an agreement with its U.K. counterpart in the early 2000s seem to illustrate the “race to coordinate” phenomenon. The SEC faced competitive pressure from the Fed and OTS; if the U.K. FSA or another EU regulator did not recognize the SEC as an “equivalent” supervisor, presumably the large U.S. investment banks, in order to maintain their access to European markets, would have
rechartered under the supervision of a U.S. regulator that had gained EU equivalence recognition. Whether or not the SEC’s Consolidated Supervised Entity program was a wise one, the story of its establishment is consistent with the alternative hypothesis presented in Part I.

IV. Case Study: The Mystery of the Missing Global Insurance Standard

The “mystery” of the missing global capital requirements for insurers and reinsurers might not seem so mysterious at first glance: insurers, as mentioned above,\(^{155}\) are less vulnerable to runs than are institutions that rely on demand deposits and short-term debt; moreover, insurers are “generally less interconnected” than banks\(^{156}\) (although the collapse of AIG arguably contradicts this conclusion).\(^{157}\) This rationale does not necessarily apply to reinsurers, however. Reinsurers take on the liabilities of primary insurance companies (in exchange for a premium), and they are also major counterparties to banks and securities firms in derivates transactions. As a 2002 IMF report noted, the simultaneous failure of several reinsurers would suddenly “leave major primary insurers with unhedged . . . exposures,” which might lead the primary insurers to “withdraw[] from capital markets, . . . attempt[] to unwind OTC derivatives hedges and liquidate part of their portfolios in order to return their financial and insurance risk profiles to more

\(^{155}\) See supra note 32.


\(^{157}\) But see Harrington, supra note 32, at 2 (“Apart from AIG, the insurance sector as a whole was largely on the periphery of the crisis. The AIG crisis was heavily influenced by its CDS portfolio, sold by a non-insurance entity, AIG Financial Products (AIGFP), which was not subject to insurance regulation.”).
desirable positions.” Moreover, the reinsurance industry is intensely competitive, and U.S. reinsurers have seen the erosion of their domestic market share in recent years. In 1996, foreign reinsurers had captured 39% of the U.S. market; by 2008, that figure had risen to 84%.

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Upon first glance, the reinsurance case might seem to support the “majority view” that regulatory fragmentation is an obstacle to cross-border coordination. Insurance and reinsurance regulation in the U.S. is highly balkanized. With the McCarran-Ferguson Act of 1945, Congress granted insurance regulatory authority to state-level supervisors. However, “issues of centralization aside, state regulators are quite powerful within their jurisdictions.” In many states, they even have the power to set prices for financial products—a power that is unique among financial service regulators in the U.S. Moreover, state insurance agencies typically have a single commissioner, whereas federal agencies usually have multiple-commissioner structures. Thus state insurance supervisors have more individual autonomy to set rules than federal financial regulators.

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160 See supra note 36.
161 See SINGER, supra note 138, at 104.
163 See SINGER, supra note 138, at 104.
165 Id.
In recent years, the Treasury Department has sought to expand its authority over the insurance and reinsurance industries. Then-Secretary Paulson’s 2008 blueprint called for the creation of a “federal insurance charter”; if an insurer opted for the federal charter, then the Treasury Department—not a state commissioner—would be the firm’s primary regulator.\(^{166}\) Although the 2009 Treasury White Paper does not incorporate this proposal, it would establish an Office of National Insurance (ONI) authorized to “negotiate international agreements . . . and coordinate policy in the insurance sector.”\(^{167}\) Senator Dodd of Connecticut incorporated a strengthened version of the ONI proposal into his financial reform bill: the Dodd proposal would allow the ONI to preempt state insurance regulations that conflict with international insurance accords.\(^{168}\) State insurance commissioners vigorously lobbied lawmakers to defeat the Dodd proposal,\(^{169}\) but the bill that emerged from a House-Senate conference in June 2010 still allows the insurance office to preempt state regulations as long as it “consult[s]” Congress.\(^{170}\)

It is too early to tell whether the Treasury’s ONI—if it is indeed established—will succeed in its efforts to coordinate insurance and reinsurance regulations with cross-border counterparts. What is clear at this early stage is that the bureaucratic advocates for cross-border coordination in insurance supervision (the Treasury officials in the Bush and

\(^{166}\) See See U.S. Dep’t of the Treasury, supra note 15.

\(^{167}\) See U.S. Dep’t of the Treasury, supra note 2, at 13.


Obama Administrations who have been pushing the ONI proposal for more than two years) are also the regulators who face the lowest autonomy costs (as Treasury has almost no authority over the insurance sector now). Meanwhile, the fiercest opponents of the ONI are state officials,\textsuperscript{171} for whom cross-border coordination would impose high autonomy costs because the state commissioners already enjoy wide discretion over insurance regulation. In short, the case study of insurance/reinsurance capital standards confirms the intuition—articulated in Part I—that the willingness of regulators to engage in cross-border coordination is inversely related to their domestic policymaking discretion.

\textbf{V. Conclusion}

This Paper has cast doubt on the conventional wisdom that regulatory consolidation at the domestic level facilitates regulatory coordination at the international level. Part I explained why the opposite might be the case: when a regulator has consolidated control over a given issue area, then the autonomy costs of cross-border coordination are especially high. By contrast, agencies in a fragmented regulatory environment may use international agreements as agenda-control devices and may leverage the legitimacy of multilateral institutions in domestic debates. Finally, domestic fragmentation may create competitive pressures, as rival regulators vie to win the “race to coordinate.” Part II showed that the Federal Reserve has adopted a go-it-alone approach

when the autonomy costs of cross-border coordination are high (e.g. on liquidity regulation and holding company rules), but the Fed has been a driving force behind the Basel Committee on Banking Supervision, which sets capital requirements for commercial banks (an issue area over which the Fed’s domestic control is severely constrained). Part III showed that the SEC changed its tune on global capital requirements for securities firms after the Gramm-Leach-Bliley Act planted the possibility that investment banks could choose the Fed or the OTS as their consolidated supervisor. This episode illustrated the role of regulatory fragmentation in fomenting competitive pressures that, in turn, increase the probability of cross-border coordination. Finally, Part IV analyzed the case of capital regulation in the insurance and reinsurance industries; although it is too soon to tell whether the Treasury Department will succeed in its efforts to negotiate international insurance agreements, the story so far suggests that the advocates for the Office of National Insurance are the regulators who will face low autonomy costs from cross-border coordination, whereas the regulators who are resisting the ONI are the state insurance commissioners for whom the corresponding autonomy costs are high.

These findings strongly suggest that Part I’s alternative hypothesis correctly characterizes the relationship between regulatory consolidation and cross-border coordination: contrary to the conventional wisdom, more consolidation will likely lead to less cross-border coordination. Does this mean that scholars and policymakers who support regulatory consolidation on the grounds that it will facilitate international cooperation should actually be advocating for further fragmentation instead?
This conclusion does not necessarily follow. From a policy perspective, what matters is not the *occurrence* of cross-border coordination but the *content* of that coordination. International regulatory coordination is not an unmitigated good. The Basel I accord, for example, “contributed to the growth in securitization by assigning lower capital charges and thus giving incentives to institutions to move their assets into off-balance-sheet securitization vehicles.”\(^{172}\) Since it was these vehicles that ultimately proved to be the undoing of Lehman Brothers\(^{173}\) (and quite nearly Citigroup as well),\(^{174}\) the case can be made that the Basel accords actually contributed to the current crisis.\(^{175}\) Moreover, a “race to compete” might lead agencies to accept ill-considered cross-border regulatory arrangements simply to preempt another domestic agency (as arguably occurred in the case of the SEC’s Consolidated Supervised Entity program with the U.K. FSA). Although the historical record strongly suggests that regulatory fragmentation will


\(^{175}\) See Demirgüç-Kunt & Servén, *supra* note 172, at 13 (“While advocates claimed that Basel II, had it been implemented earlier, could have lessened or promoted the turmoil, critics of the Basel approach . . . pointed out that the crisis has simply reconfirmed fundamental flaws that have been evident in this approach.”); Friedman & Kraus, *supra* note 172, at 1 (“Powerful evidence suggests that the recourse rule, and other variants of Basel regulations on commercial banks’ capital, caused the crisis.”).
generate more international agreements, it will not necessarily generate better international agreements.

Ultimately, the desirability of regulatory consolidation depends on a complicated calculus of costs and benefits. Fragmentation may allow firms to engage in regulatory arbitrage, choosing the supervisor whose standards are most lax. At the same time, consolidation creates the risk of “capture of the regulatory mothership”: whereas oversight lapses at the OTS only affected a small fraction of U.S. banks (and one very large insurer), a top-down failure at a consolidated regulator could have truly catastrophic consequences. Perhaps even more important than the question of whether to have a consolidated regulator is the question of who the consolidated regulator should be.

The Federal Reserve brings the advantages of institutional independence and vastly superior resources (as its budget is not dependent on congressional appropriations), however, the Fed (and particularly its New York branch) also has a historically cozy relationship with the money center banks. The FDIC has won admirers as a result of its chairwoman’s crusading approach to regulation; however, it has less experience than

179 See GOV’T ACCOUNTABILITY OFFICE, supra note 141.
the Fed and the OCC in overseeing complex multinational financial institutions such as
the large investment banks.\textsuperscript{182}

This Paper does not seek to resolve the debate over regulatory consolidation once
and for all. Rather, my point is that in deciding whether to consolidate regulatory
responsibilities in a particular agency, we must weigh the pros and cons carefully, and the
balance may be a close one. Several commentators have suggested that balance should tip
in favor of regulatory consolidation because consolidation will facilitate cross-border
coordination.\textsuperscript{183} As the preceding Parts have shown, this “benefit” of consolidation is
illusory. It would be a shame if the debate over consolidation were decided based on a
misguided belief in a “benefit” that does not in fact exist.

\textsuperscript{182} See Peter J. Wallison & David Skeel, \textit{The Dodd Bill: Bailouts Forever}, \textit{Wall St. J.},
(“the FDIC is completely unequipped by experience to handle the failure of a giant
nonbank financial institution”).

\textsuperscript{183} See \textit{supra} text accompanying notes 7-15.