

Regulatory Consolidation and Cross-Border Coordination: Challenging the Conventional Wisdom

Daniel Hemel[†]

The conventional wisdom among scholars and policymakers holds that international regulatory coordination is more likely to arise when regulatory authority at the domestic level is consolidated within a single body rather than dispersed across an array of agencies. Many prominent participants in the ongoing debate over U.S. regulatory reform—including former Treasury Secretary Hank Paulson and former Federal Reserve Chairman Paul Volcker—have cited this supposed connection between domestic regulatory consolidation and cross-border coordination as a reason to reduce the number of U.S. agencies that share supervisory authority over the financial sector. Scholars, however, have not rigorously tested this hypothesis.

This Note is a first step toward filling this gap. It examines how changes in U.S. domestic regulatory structures across the commercial banking, securities, and insurance sectors have shaped cross-border coordination over the last twenty-five years. These case studies suggest a surprising conclusion: contrary to the conventional wisdom, regulatory consolidation at the domestic level appears to be negatively correlated with cross-border coordination. When regulatory authority is fragmented among several agencies at the domestic level, U.S. financial regulators turn to their cross-border counterparts in order to circumvent roadblocks erected by domestic rivals. By contrast, in areas where a single regulatory agency enjoys consolidated control over a particular policy matter at the domestic level, that agency is less willing to restrict its policymaking discretion through an international agreement.

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[†] Yale Law School, J.D. expected, 2012; M.Phil, International Relations, University of Oxford, 2009. I would like to thank Yuen Foong Khong, Kalypso Nicolaidis, Ngaire Woods, and (especially) Walter Mattli of the University of Oxford Department of Politics and International Relations for their guidance on this project; the Marshall Scholarship for funding this research; and Eric Hemel for thoughtful comments that vastly improved this Note. Finally, I would like to thank Sebastian Swett and the staff of the *Yale Journal on Regulation* for their excellent editing work.

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Introduction

The global financial crisis of 2007-2010 has galvanized movement toward 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 (“SEC”) with the Commodity Futures Trading Commission (“CTFC”) and to consolidate the Office of Thrift Supervision (“OTS”), which oversees federally chartered savings and loan associations, into the Office of the Comptroller of the Currency (“OCC”), which oversees federally chartered banks.¹ Although the Obama Administration ultimately dropped Paulson’s proposal for an SEC-CFTC merger, the Dodd-Frank Wall Street Reform and Consumer Protection Act, which President Obama signed in July 2010, folded the OTS into the OCC² and

1. Press Release, Henry M. Paulson, Jr., U.S. Sec’y of the Treasury, Remarks on Blueprint for Regulatory Reform (Mar. 31, 2008), available at <http://www.ustreas.gov/press/releases/hp897.htm>.

2. See Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 312(b)(2)(B), 124 Stat. 1376, 1522 (to be codified at 12 U.S.C. § 5412) (transferring supervisory authority over federal savings associations from the OTS to the OCC); see also Jon Prior, *OCC, OTS Merger Going ‘Rockier’ than Expected*, HOUSINGWIRE (Nov. 8, 2010, 4:31 PM), <http://www.housingwire.com/2010/11/08/occ-ots-merger-may-be-going-rockier-than-expected> (noting that 600 to 700 employees will transfer from the OTS to the OCC by July 2011). Of the 734 institutions currently supervised by the OTS, 673 are federal savings associations and 61 are state savings associations. See Office of Thrift Supervision, Institution Search,

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further centralized supervisory responsibilities in a new Financial Stability Oversight Council chaired by the Secretary of the Treasury.³ At the same time, as the Obama Administration and its allies in Congress have taken steps to reduce the fragmentation of regulatory authority at the domestic level, the Administration and its international counterparts are seeking to promote closer coordination among financial regulators across borders.⁴ In a 2009 “white paper,” the Obama Administration’s Treasury Department called for the “continued operational development of supervisory colleges” that would bring together regulators from various countries who oversee the thirty largest global financial institutions.⁵ Meanwhile, regulators from the United States and other industrialized nations have agreed on new global banking rules (the so-called “Basel III”) that are scheduled to take effect beginning in 2013.⁶ Throughout the regulatory reform process, the Obama Administration has emphasized that its twin goals of domestic regulatory consolidation and cross-border regulatory coordination are “consistent” with one another.⁷

Scholars specializing in financial regulation have echoed the Obama Administration’s assumption that domestic regulatory consolidation and international regulatory coordination are complementary—perhaps even mutually dependent. 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.⁸ 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

<http://www.ots.treas.gov/?p=InstitutionSearch> (last visited Dec. 4, 2010). Under the Dodd-Frank Act, the FDIC will assume authority over the 61 state associations. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 312(b)(2)(C).

3. *Id.* § 111.

4. See Letter Co-Signed by Nicholas Sarkozy, President of the Republic of Fr., Barack Obama, President of the U.S., et al., to the G20 Heads of State and Gov’t (Mar. 30, 2010), available at <https://pastel.diplomatie.gouv.fr/editorial/actual/acl2/bulletin.gb.asp?liste=20100331.gb.html&submit.x=12&submit.y=5&submit=consulter#Chapitre2>.

5. See U.S. DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 81 (2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

6. *New Bank Rules To Curb Risk*, CNNMONEY.COM (Sept. 12, 2010, 4:04 PM), http://money.cnn.com/2010/09/12/news/economy/Basel_global_banking_regulations.

7. See U.S. DEP’T OF THE TREASURY, *supra* note 5, at 80.

8. David Andrew Singer, *The Subprime Accountability Deficit and the Obstacles to International Standards Setting*, 15 GLOBAL GOVERNANCE 23, 26-27 (2010) [hereinafter Singer, *Subprime Accountability Deficit*]; see also David Andrew Singer, *Capital Rules: The Domestic Politics of International Regulatory Harmonization*, 58 INT’L ORG. 531 (2004) [hereinafter Singer, *Capital Rules*]; David Andrew Singer, *Uncertain Leadership: The U.S. Regulatory Response to the Global Financial Crisis*, in GLOBAL FINANCE IN CRISIS: THE POLITICS OF INTERNATIONAL REGULATORY CHANGE 93 (Eric Helleiner, Stefano Pagliari & Hubert Zimmermann eds., 2009) [hereinafter Singer, *Uncertain Leadership*].

international supervisory standards.”⁹ 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.”¹⁰ Numerous other scholars have repeated the conventional wisdom that domestic regulatory fragmentation impedes cross-border coordination.¹¹

Outside of the academy, the view that domestic regulatory fragmentation has hindered international cooperation increasingly influences debates about the structure of financial supervision. A 2004 World Bank publication stated that one advantage of regulatory consolidation is that it “facilitates international cooperation.”¹² The Group of Thirty, a consultative body 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.”¹³ 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.”¹⁴ The panel concluded that the OCC, the OTS, the Federal Deposit Insurance Corporation (“FDIC”), the SEC, and the CFTC should “all be merged and consolidated.”¹⁵ 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.”¹⁶

9. Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39, 101 (2009).

10. John C. Coffee, Jr., *Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 BUS. LAW. 447, 482 (1995).

11. See, e.g., Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 49 (2005) (“[T]he fractured nature of the U.S. financial regulatory regime has negatively affected efforts by U.S. regulators to participate effectively in international forums.”); John R. Dearie & George J. Vojta, *Reform and Modernization of Financial Supervision in the United States: A Competitive and Prudential Imperative 3* (May 9, 2007), available at <http://fic.wharton.upenn.edu/fic/glbaplus.pdf> (“[T]he complexity and inconsistencies of the U.S. framework of financial supervision . . . represent a major obstacle to greater international cooperation among financial supervisors.”).

12. See Jeffrey Carmichael, *Summary of the Discussion*, in *ALIGNING FINANCIAL SUPERVISORY STRUCTURES WITH COUNTRY NEEDS I*, 3 (Jeffrey Carmichael, Alexander Fleming & David Llewellyn eds., World Bank Inst., 2004).

13. THE GROUP OF THIRTY, *FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY* 35 (2009), available at <http://www.group30.org/pubs/reformreport.pdf>.

14. COMMITTEE ON CAPITAL MARKETS REGULATION, *THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM* 206 (2009), available at [http://www.capmksreg.org/pdfs/TGFC-CCMR_Report_\(5-26-09\).pdf](http://www.capmksreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf).

15. *Id.* at 203.

16. U.S. DEP’T OF THE TREASURY, *BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE* 115 (2008).

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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 ever seriously questioning it. But as this Note argues, this assumption does not stand up to scrutiny. Through case studies of banking, securities, and insurance regulation, this Note 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”;¹⁷ 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 seeking 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, international law scholars 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”¹⁸ 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.”¹⁹ Verdier and Whytock have correctly identified domestic regulatory consolidation as an important independent variable affecting the probability of cross-border coordination; however, as this Note will demonstrate, the effect is the exact *opposite* of the effect that Verdier and Whytock predict.

This Note’s argument also informs ongoing policy debates regarding regulatory consolidation. Domestic regulatory consolidation may be desirable for reasons *unrelated* to its international effects,²⁰ but the often-repeated

17. See *supra* text accompanying note 12.

18. Pierre-Hugues Verdier, *Transnational Regulatory Networks and Their Limits*, 34 YALE J. INT’L L. 113, 170 (2009).

19. Christopher A. Whytock, *A Rational Design Theory of Transgovernmentalism: The Case of E.U.-U.S. Merger Review Cooperation*, 23 B.U. INT’L L.J. 1, 31 (2005).

20. 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 with the power to serve as the single regulator for banks, securities firms, and insurers. See Howard Davies, *Reforming Financial Regulation*, in REGULATING FINANCIAL SERVICES AND MARKETS IN THE 21ST CENTURY 17, 19 (Eilís Ferran & Charles A.E. Goodhart eds., 2001) (noting that the Financial Services and Markets Act was the subject of some 200 hours of parliamentary debate). Arguments in favor of the single-regulator model—which ultimately carried the day in the United Kingdom—are summarized in Clive Briault, *The Rationale for a Single National Financial Services Regulator* (Fin. Serv. Auth., Occasional Paper Series, Working Paper No. 2, 1999), available at <http://ssrn.com/abstract=428086>. According to Briault, regulatory consolidation generates “economies

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 they correctly assess the relationship between agency consolidation and cross-border coordination, they run the risk of making major decisions about regulatory structure based on faulty conventional wisdom.

Part I of this Note 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 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 Note 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 (for example, 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, 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. This Part explores the relationship between regulatory fragmentation at the domestic level and the

of scale and scope," *id.* at 18; produces "a . . . more efficient . . . allocation of regulatory resources across both regulated firms and types of regulated activities," *id.* at 20; creates a check against regulatory arbitrage, *id.* at 22; and establishes clear lines of accountability, *id.* at 22-23. On the other hand, 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. RES. BANK OF CHI. ECON. PERSP., 3d Q. 2005, at 16, 31; see also *id.* at 31 ("My results imply that banks switching regulators . . . increased return [on assets] without a rise in bank failures.") A full analysis of the advantages and disadvantages of regulatory consolidation lies beyond the scope of this Note. Rather, this Note 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.

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Treasury Department's decision to pursue its policy objectives through multilateral channels.

Finally, 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. This Note argues for a reexamination of the interplay between domestic regulatory agencies and international coordination.

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, that is, 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 that domestic consolidation is negatively correlated with cross-border coordination. This Part explains the intuitions underlying each of these perspectives. The remainder of this Note will test these three hypotheses against the historical record.

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.²¹ Simmons sees regulation as a two-stage process. At the first stage, the United States adopts a particular policy for its capital markets, and other countries react to the U.S. policy (or the United States “anticipat[es] . . . the reactions of the rest of the world”²² when those reactions are relatively predictable). At the second stage, the United States determines whether other countries' reactions have resulted in negative externalities for U.S. firms and U.S. markets. If they have, the United States uses coordination to mitigate these externalities as much as possible. Although Simmons would acknowledge that

21. See Beth A. Simmons, *The International Politics of Harmonization: The Case of Capital Market Regulation*, 55 INT'L ORG. 589, 596-600 (2001).

22. *Id.* at 596.

domestic regulatory structure may have an effect on outcomes at stage one,²³ her theory holds that domestic regulatory structure has a null effect at stage two on the decision whether to coordinate with cross-border counterparts.²⁴ From this Note'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's, then foreign financial institutions may take 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 in the 1974 liquidation of Germany's Herstatt Bank and in the 1982 collapse of Italy's Banco Ambrosiano illustrated).²⁵ 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.”²⁶ From Simmons's perspective, the case of capital adequacy regulation supports the externalities argument: the United States *did* suffer from negative externalities, and the United States *did* respond by promoting the Basel I Accord for commercial banks.²⁷

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 historically been much more extensive in commercial banking than in the securities and insurance industries, and the scholarly consensus (at least prior to

23. *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.

24. *See* Simmons, *supra* note 21, at 596.

25. *See* Ethan B. Kapstein, *Resolving the Regulator's Dilemma: International Coordination of Banking Regulation*, 43 *INT'L ORG.* 323, 325 (1989).

26. *See id.* at 327.

27. Simmons, *supra* note 21, at 601-05.

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the Lehman Brothers collapse and the near-failure of the insurer AIG in September 2008) held that the systemic risks inherent in commercial banking exceed those of the latter two sectors. Before proceeding further, it is important to distinguish between *solvency* risk (that is, the risk that a firm will not have sufficient assets to cover its liabilities) and *liquidity* risk (that is, 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 calculated the Z-score—“the number of standard deviations below the mean by which profits must fall to bankrupt the firm”—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.²⁸ 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.²⁹ By contrast, securities firms and insurance companies “are not reliant on first-come, first-served demand liabilities, and so they are not vulnerable . . . to subsequent pressures to liquidate assets rapidly in order to meet the demands of creditors.”³⁰ The apparent fact that commercial banks are more vulnerable to “runs” than are securities firms and insurers might

28. Cara S. Lown et al., *The Changing Landscape of the Financial Services Industry: What Lies Ahead?*, 6 FED. RES. BANK OF N.Y. ECON. POL’Y REV. 39, 45, 46 tbl.6 (2000).

29. 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).

30. *Id.* at 21, 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 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 (Ind. State Univ., Network Fin. Inst., Policy Brief No. 2010-PB-02, 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*, ISSUE ANALYSIS (Nat’l Ass’n of Mut. Ins. Cos., Indianapolis, Ind.), Sept. 2009, at 3 (concluding that “[s]ystemic risk is low in insurance markets compared with banking”). *But see* Peter Boone & Simon Johnson, *Waiting for the Next Lehman*, SUNDAY TIMES (London), Sept. 13, 2009, at 8, available at 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”). See generally George G. Kaufman, *Bank Contagion: A Review of the Theory and Evidence*, 8 J. FIN. SERVICES RES. 123, 125 (1994) (“[U]nlike banks, nonbanks . . . have relatively little demand or very short-term debt that can run in response to [an] adverse shock.”).

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.³¹ 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 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.³² 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.³³ Indeed, U.S. commercial banks have protected their market share more effectively than many other U.S. financial services providers. For example, whereas foreign-owned banks now account for approximately 13% of all U.S. commercial banking sector assets, foreign reinsurers control more than 80% of the U.S. unaffiliated reinsurance premium market.³⁴

31. 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.”).

32. 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.”).

33. On entry barriers and switching costs in commercial banking, see Doris Neuberger, *Industrial Organization of Banking: A Review*, 5 INT’L J. 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, 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.”).

34. *Compare Assets and Liabilities of Commercial Banks in the United States* 3, 19, BD. OF GOVERNORS OF THE FED. RESERVE SYS., <http://www.federalreserve.gov/releases/h8/20101126> (last updated Nov. 26 2010) (showing that foreign-related institutions hold \$1.062 trillion in U.S. deposits, or 13% of the \$7.921 trillion of total U.S. commercial bank deposits), with *Issue Update: Reinsurance*, INS. INFO. INST., <http://old.iii.org/media/hottopics/insurance/reinsurance> (last updated June 2009) (stating that offshore reinsurers, along with U.S. subsidiaries of offshore reinsurers, controlled 83.4% of the U.S. unaffiliated reinsurance premium market in 2007). The unaffiliated reinsurance premium market consists of premiums ceded to reinsurers who are not corporate affiliates of the primary insurer. *Id.*

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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.

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 Coffee writes, “it may be easier for a consolidated agency to . . . negotiate for ‘harmonized’ international standards than for a bifurcated structure to do so.”³⁵ The second focuses on the *willingness* of regulators to engage in cross-border coordination. According to Singer, regulatory fragmentation allows agencies to play a domestic “blame game” instead of addressing systemic risks through multilateral institutions.³⁶

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.”³⁷ Meanwhile, the OTS was the agency officially tasked with the responsibility of coordinating with EU regulators regarding AIG,³⁸ but the OTS had no office in the United

35. Coffee, *supra* note 10, at 482.

36. See Singer, *Uncertain Leadership*, *supra* note 8, at 101.

37. COMMODITY FUTURES TRADING COMM’N, FY 2008 PRESIDENT’S BUDGET AND PERFORMANCE PLAN 78 (2007), available at <http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/2008budgetperf.pdf>; see also Jeremy Grant, *Concern Grows over Budget for CFTC Regulation*, FIN. TIMES, Mar. 11, 2007, <http://www.ft.com/cms/s/2b51ab1c-cfdc-11db-94cb-000b5df10621.html>.

38. Jeff Gerth, *Was AIG Watchdog Not Up to the Job?*, PROPUBLICA, Nov. 10, 2008, <http://www.propublica.org/feature/was-aig-watchdog-not-up-to-the-job>.

Kingdom (or anywhere else in Europe)³⁹ from which to oversee the AIG London unit that reportedly “managed \$2 trillion in derivative trades.”⁴⁰ According to the majority view, regulatory fragmentation leads to circumstances in which a small agency may be “out of its league”⁴¹ 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.⁴² Advocates of consolidation say that a streamlined regulatory structure will allow the United States to speak with one voice on international regulatory issues.⁴³

One leading exponent of this “majority view,” Singer, has argued that regulators with consolidated authority at the domestic level not only find that they have greater capacity to engage in cross-border coordination, but also that they have a stronger self-interest in doing so. According to Singer, “[p]olitical pressure from Congress must . . . be direct and unambiguous in order to spur regulators to press forward on the international front.”⁴⁴ Moreover, legislators will only hold regulators accountable when either (1) “[r]egulations that are too lax . . . contribute to faltering firms and a crisis of confidence among voters,” or (2) “regulations that are too strict . . . put domestic firms at a competitive disadvantage.”⁴⁵ Under these conditions, legislators may remove regulatory responsibilities from an agency or, as a more drastic measure, abolish the

39. See *OTS Contacts*, OFFICE OF THRIFT SUPERVISION, <http://www.ots.treas.gov/?p=ContactOTS> (last visited May 27, 2010). Other agencies have more extensive overseas operations. The OCC, for example, has a London office, see *Large Bank Examiners In-Charge*, COMPTROLLER OF THE CURRENCY, <http://www.occ.treas.gov/lbdist.htm> (last visited May 27, 2010), and the SEC has a “long history of . . . involvement with international markets” dating back to the Commission’s beginnings during the Great Depression, see Felice Batlan, *The Imperial SEC?: Foreign Policy and the Internationalization of the Securities Markets, 1934-1990*, SEC HISTORICAL, <http://www.sechistorical.org/museum/galleries/imp> (last updated Dec. 1, 2008).

40. Karen Gullo, *Former AIG Executive Cassano Said Not To Face Charges in Insurer’s Failure*, BLOOMBERG, May 22, 2010, <http://www.bloomberg.com/apps/news?pid=20601087&sid=auksbwRhTw7w>.

41. See Adriane Fresh & Martin Neil Baily, *What Does International Experience Tell Us About Regulatory Consolidation?* 3 (Pew Econ. Policy Dep’t, Fin. Reform Project, Briefing Paper No. 6, 2009), available at <http://fic.wharton.upenn.edu/fic/Policy%20page/Fresh-Baily-International-Final-TF-Correction.pdf>.

42. See Singer, *Subprime Accountability Deficit*, *supra* note 8, at 27 (“Consider the immense challenges of creating a global standard . . . when the agencies *within* the United States are at odds with one another.”).

43. See, e.g., *Systemic Risk and Insurance: Hearing Before the Subcomm. on Capital Markets, Ins., and Gov’t Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. 18-20 (2009) (statement of Franklin W. Nutter, President, Reinsurance Association of America).

44. See Singer, *Subprime Accountability Deficit*, *supra* note 8, at 25.

45. See Singer, *Capital Rules*, *supra* note 8, at 536.

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agency entirely.⁴⁶ 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.”⁴⁷ However, according to Singer, “regulatory accountability in the US is muddled and fragmented,” and as a result, agencies are *not* being held accountable in the current crisis.⁴⁸ 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,⁴⁹ Congress responded by *expanding* the power of the SEC through the Sarbanes-Oxley Act of 2002.⁵⁰ Similarly, despite the Federal Reserve’s regulatory failures in the run-up to the recent financial crisis,⁵¹ 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”).⁵² Although there are counterexamples in which Congress has abolished an agency in response to a regulatory failure,⁵³ the correlation between crisis and autonomy is not clear-cut: regulators who fail to “maintain a balance between confidence and competitiveness”⁵⁴ are just as likely to *gain* new powers as to lose them. Second, it seems, at least intuitively, that Congress

46. *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 Bank Board 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.).

47. Singer, *Capital Rules*, *supra* note 8, at 561.

48. Singer, *Uncertain Leadership*, *supra* note 8, at 100.

49. SENATE COMM. ON HOMELAND SEC. & GOV’T AFFAIRS, FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 2 (2002), *available at* <http://hsgac.senate.gov/100702watchdogsreport.pdf>.

50. 15 U.S.C. § 7245 (2006); *see also* Jonathan R. Macey, *Regulatory Globalization as a Response to Regulatory Competition*, 52 EMORY L.J. 1353, 1364-65 (2003) (noting that Sarbanes-Oxley allowed the SEC to act *without* coordinating with cross-border counterparts and concluding that, “ironically, crisis reduces rather than increases regulators’ desire to participate in the globalization process”).

51. *See* William K. Black, *Anti-Regulators: The Federal Reserve’s War Against Effective Regulation*, HUFFINGTON POST, Jan. 11, 2010, http://www.huffingtonpost.com/william-k-black/anti-regulators-the-feder_b_418568.html.

52. Neil Irwin, *For Fed, Overhaul To Bring Wider Reach*, WASH. POST, May 25, 2010, at A17, *available at* <http://www.washingtonpost.com/wp-dyn/content/article/2010/05/24/AR2010052404028.html?hpid=topnews>.

53. The abolition of the Federal Home Loan Bank Board, *see supra* note 46, and the impending abolition of the OTS, *see supra* text accompanying note 2, are examples.

54. Singer, *Capital Rules*, *supra* note 8, at 561.

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”⁵⁵ 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.

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

This Note suggests an original, alternative hypothesis: regulatory consolidation at the domestic level may *decrease* the probability of coordination at the international level. Conceptually, there are four reasons why we might expect this to be the case. First, a regulatory agency will incur higher “autonomy costs”⁵⁶ as a result of cross-border coordination when domestic regulatory authority is consolidated. 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”⁵⁷ 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”⁵⁸

55. *Id.*

56. On “autonomy costs” as a disincentive to regulatory coordination, see Miles Kahler & David A. Lake, *Economic Integration and Global Governance: Why So Little Supranationalism*, in *THE POLITICS OF GLOBAL REGULATION* 242, 264 (Walter Mattli & Ngaire Woods eds., 2009).

57. For a formal analysis of agenda control and its importance in political bodies, see Richard D. McKelvey, *Intransitivities in Multidimensional Voting Models and Some Implications for Agenda Control*, 12 *J. ECON. THEORY* 472 (1976).

58. See, e.g., Neil Craik & Joseph DiMento, *Environmental Cooperation in the (Partially) Disaggregated State: Lessons from the Security and Prosperity Partnership of North America*, 8 *CHI. J. INT’L L.* 479, 483 (2008) (defining “expert legitimacy” as a form of legitimacy “whereby the authority exercised by networks is justified on the basis of the qualifications of its members to solve technical problems”).

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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 partners abroad.

1. Autonomy Costs

Theories of regulation are often categorized as either “public interest” theories or “public choice” theories.⁵⁹ 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.”⁶⁰ Public choice theory assumes that regulators are “rationally self-interested” individuals who seek to capture rents for either themselves or their benefactors.⁶¹

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 regulators because “whatever else they desire,” autonomy is “necessary to achieve it.”⁶² Enrico Colombatto and Jonathan Macey, who describe themselves as followers of the “public choice” school of thought, argue that self-interested regulators covet autonomy because they seek “to maximize the rough value of their bureaucracies.”⁶³ Other scholars see a link

59. See, e.g., Michael Hantke-Domas, *The Public Interest Theory of Regulation: Non-Existence or Misinterpretation*, 15 EUR. 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.”).

60. Cf. Walter Mattli & Ngaire Woods, *In Whose Benefit? Explaining Regulatory Change in Global Politics*, in THE POLITICS OF GLOBAL REGULATION, *supra* note 56, at 1, 9 (critically evaluating public interest and public choice theories).

61. See, e.g., Enrico Colombatto & Jonathan R. Macey, *A Public Choice Model of International Economic Cooperation and the Decline of the Nation State*, 18 CARDOZO L. REV. 925, 929 (1996).

62. DANIEL P. CARPENTER, THE FORGING OF BUREAUCRATIC AUTONOMY: REPUTATIONS, NETWORKS, AND POLICY INNOVATION IN EXECUTIVE AGENCIES 374-75 n.16 (2001).

63. Colombatto & Macey, *supra* note 61, at 933 (citation omitted); *see also* JAMES Q. WILSON, BUREAUCRATS: WHAT GOVERNMENT AGENCIES DO AND WHY THEY DO IT 195 (1989) (“Autonomy is

between regulatory autonomy and the pursuit of the public interest.⁶⁴ 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.⁶⁵ It may also be that SEC officials sincerely view their agency as a more competent securities regulator than the CFTC or other challengers to the SEC’s incumbency.⁶⁶ While this Note takes no sides in the public interest/public choice debate, it appears that *regardless* of whether regulators behave in their own interests or in the interests of society at large, they value autonomy as a means for achieving whatever end they adopt.

Thus, public interest and public choice theorists alike can agree with Colomatto 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.”⁶⁷ When regulators reach agreements with their cross-border counterparts, they incur “autonomy costs”⁶⁸ 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. In contrast, a regulator whose discretion is *already* quite constrained will see that she has less to lose if she binds herself to an international accord.

2. Agenda Control

Not only may cross-border coordination lead to lower *costs* for a regulator in a fragmented environment, but it may also bring greater benefits. Specifically, international agreements may serve as tools for *agenda control*. Imagine three regulators (1, 2, and 3) 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

valued [by agencies] at least as much as resources, because autonomy determines the degree to which it is costly to acquire and use resources.”).

64. 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., Ernest T. Patrikis & John R. Dearie, *Supervisory Power Is Critical to Fed’s Rule*, POLITICO, Mar. 1, 2010, <http://www.politico.com/news/stories/0210/33659.html> (arguing that the “Fed . . . has unrivaled institutional experience as a supervisor”).

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

67. Colomatto & Macey, *supra* note 61, at 926.

68. See Neil S. Siegel, *International Delegations and the Values of Federalism*, 71 LAW & CONTEMP. PROBS. 93, 94 n.6 (2008); see also Kahler & Lake, *supra* note 56.

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generates a consensus (or even a majority).⁶⁹ The consequence is a voting “cycle”: “policy proposals can just go around and around with no end.”⁷⁰ The cycle will end only if one actor delimits the menu of options.⁷¹

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 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 Note shows how the Federal Reserve used a similar strategy to cut through regulatory gridlock at several points in the late 1980s.

3. Importing Credibility

International organizations—especially those with long histories and large professional staffs—acquire “expert legitimacy” on the basis of their technical capabilities and reputations for competence. International organizations can “wrap . . . a cloak of scientific respectability” around a regulator’s policy proposals.⁷² 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.⁷³ Thus, regulators may be willing to incur some autonomy costs in order to acquire this “cloak.” However, the cloak will be most necessary to a regulator who cannot adopt domestic policies on its own—for example, a regulator who needs to build a coalition of political actors in order to achieve its policy preference. In other words, the cloak has greater value to a regulator in a fragmented system whose policymaking discretion is constrained by domestic rivals than to a regulator who already enjoys broad domestic autonomy. 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 Fed also leveraged the expert legitimacy of the Basel Committee in order to justify its

69. See Kenneth J. Arrow, *A Difficulty in the Concept of Social Welfare*, 58 J. POL. ECON. 328, 328-30 (1950).

70. Rachel Brewster, *The Domestic Origins of International Agreements*, 44 VA. J. INT’L L. 501, 527 (2004).

71. See KENNETH J. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (2d ed. 1963).

72. Daniel Bodansky, *The Legitimacy of International Governance: A Coming Challenge for International Environmental Law?*, 93 AM. J. INT’L L. 596, 620 (1999).

73. *Id.* (citation omitted).

“value-at-risk” approach to capital regulation in the early 2000s. Section II.C will explore this episode in further detail.

4. 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 Note shows how “first to coordinate” pressures drove the SEC toward an agreement with the U.K. Financial Services Authority (“FSA”) 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.”⁷⁴ 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.⁷⁵ Accordingly, the following Parts will examine the three traditional financial services sectors—banking, 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 (when cross-border coordination *does* occur) and cases in which the value of the dependent variable is negative (when it does *not*), this Note seeks to provide a fuller account of the relationship between domestic regulatory consolidation and international outcomes.

74. On the importance of “nonbarking dogs” in case study analysis, see generally James Mahoney & Gary Goertz, *The Possibility Principle: Choosing Negative Cases in Comparative Research*, 98 AM. POL. SCI. REV. 653, 653 (2004) (“A central challenge in qualitative research is selecting the ‘negative’ cases (e.g., nonrevolutions, nonwars) to be included in analyses that seek to explain positive outcomes of interest (e.g., revolutions, wars). . . . [I]t is widely recognized that the selection of negative cases is consequential for theory testing . . .”).

75. On the pitfalls of “selecting on the dependent variable” in comparative case study research, see BARBARA GEDDES, *PARADIGMS AND SAND CASTLES: THEORY BUILDING AND RESEARCH DESIGN IN COMPARATIVE POLITICS* 91 (2003) (“The adverse effects of selecting cases for study on the dependent variable stem from the logic of inference. When one sets out to explain why countries A and B have, say, developed more rapidly than countries C through I, one is implicitly looking for some antecedent factors X through Z that countries A and B possess in greater degree than do countries C through I. The crux of the difficulty that arises when cases are selected on the dependent variable is that if one studies only countries A and B, one can collect only part of the information needed, namely, the extent of factors X through Z in countries A and B. Unless one also studies countries C through I (or a sample of them) to make sure they have less of X through Z, one cannot know whether the factors identified really vary with the outcome under investigation.”).

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

A. *The Basel I Accord*

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 (requiring \$4 in Tier 1 capital for every \$100 of corporate debt on a bank’s balance sheet).⁷⁶ Twelve industrialized countries agreed to impose this common regulatory scheme on their banks, with the requirements taking effect by 1992.⁷⁷

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.⁷⁸ Yet, more than one-and-a-half decades would elapse before U.S. and EU 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?

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.⁷⁹ Second, U.S. and U.K. regulators sought to achieve a “level playing field”⁸⁰ for their banks vis-à-vis Japanese competitors. Before Basel, Japanese banks carried less capital than

76. See Bank for Int’l Settlements, Basle Comm. on Banking Supervision, International Convergence of Capital Measurement and Capital Standards (July 1988), available at <http://www.bis.org/publ/bcbs04a.htm>.

77. 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, at D1 (summarizing the elements of the Accord).

78. James R. Kraus, *Global Dispatches: More Eyes on Conglomerates Urged by Bank Supervisors*, AM. BANKER, Oct. 12, 1990, at 8.

79. See Kapstein, *supra* note 25; Simmons, *supra* note 21, at 601-02.

80. Kapstein, *supra* note 25, at 339. Kapstein notes, however, that Basel I, “while theoretically leveling the playing field between international commercial banks, will now tip the field in favor of nonbank financial institutions.” *Id.* at 345.

their U.S. counterparts, which presumably tilted the field in the 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.⁸¹ Although Basel I would require Japanese banks to raise more equity than American banks, the total cost of *complying* with Basel I (that is, 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.⁸²

Yet, the Federal Reserve officials *did* press for a global bank capital standard, despite evidence that the “level playing field” argument was illusory.⁸³ What explains the U.S. central bank's persistent promotion of global capital standards? The majority view 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 United States is severely fractured. The Federal Reserve is the primary regulator for only one-tenth of U.S. depository institutions. A separate agency, the 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, which means that the OCC ultimately supervises 61% of all bank *assets*.⁸⁴ Whether we measure by

81. According to a Bank for International Settlements report, the cost of equity for Japanese banks between 1984 and 1988 was 3.2%, compared to 12% for U.S. banks. Patricia Jackson, et al., *Capital Requirements and Bank Behaviour: The Impact of the Basle Accord* 41 tbl.4.2 (Basle Comm. on Banking Supervision, Working Paper No. 1, 1999), available at http://www.bis.org/publ/bcbs_wp1.pdf.

82. By one estimate, Japanese banks needed to raise \$70 billion to meet the Basel requirements, whereas U.S. banks needed to raise \$30 billion. See John Evans, *Japanese Banks Raised \$50 Billion in Capital over 2 Years, Official Says*, AM. BANKER, Jul. 6, 1989, at 1. If these and the BIS cost-of-equity figures are accurate, see Jackson et al., *supra* note 81, then the annual cost of Basel compliance for the Japanese banking industry was \$2.2 billion, compared to \$3.6 billion for the U.S. banking industry.

83. On the “decisive leadership” of the Federal Reserve and the Bank of England in the Basel I process, see Kapstein, *supra* note 25, at 324.

84. See Fed. Deposit Ins. Corp., *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

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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.

Table 1: Institutions and Assets Supervised by U.S. Bank Regulatory Agencies (2008 FDIC Data)

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

*Dollar amounts and percentages do not sum to total due to rounding.

Source: FDIC, *supra* note 84.

After the collapse of Continental Illinois National Bank in 1984—the largest failure of a U.S. depository institution until that time⁸⁵—federal regulators from all the agencies agreed that *something* needed to be done to shore up bank balance sheets. The largest U.S. banks had made massive loans to Latin American governments, and those loans now appeared to be on the verge of default.⁸⁶ However, each regulator had a different policy preference.

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.

85. For an overview of the events leading up to the Continental Illinois collapse and the resulting ramifications for financial markets, see Itzhak Swary, *Stock Market Reaction to Regulatory Action in the Continental Illinois Crisis*, 59 J. BUS. 451 (1986).

86. James Kraus, *New Maneuvers in '87 Curbed Banks' Loan Exposure*, AM. BANKER, Jan. 18, 1988, at 2.

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 (such as Treasury bonds) to riskier ones (such as commercial loans and third-world government debt).⁸⁷ To counter this threat, the Fed, under Chairman Paul Volcker, sought to impose a “risk bucket” approach, which would require banks to carry more equity if they held riskier assets on their balance sheets.⁸⁸ Volcker hoped that this approach would encourage banks to adopt prudent policies.

However, Volcker faced resistance on three fronts. First, 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).⁸⁹ Second, 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 involve federal authorities in banks’ credit allocation decisions.⁹⁰ Third, 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 Chairman William Seidman was among the Volcker plan’s most vocal critics.⁹¹ The FDIC already had its own system to assess bank risk, the so-called CAMEL⁹² rating scheme. Like the Volcker plan, CAMEL accounted for the size of a bank’s capital cushion and the riskiness of its assets, but CAMEL also allowed FDIC supervisors to evaluate management quality, earnings streams, and liquidity.⁹³ FDIC officials believed that CAMEL offered a better measure of bank stability than risk-based capital ratios.⁹⁴ Moreover, as

87. Nathaniel C. Nash, *New Bank Rules by Fed*, N.Y. TIMES, Mar. 2, 1985, at A37.

88. Nina Easton, *Big Banks To Feel Brunt of Risk-Based Capital Plan*, AM. BANKER, Jan. 16, 1986, at 1.

89. Nina Easton, *Justice Department Urges Fed To Amend Risk-Based Proposal*, AM. BANKER, May 29, 1986, at 1.

90. Barbara A. Rehm, *Seiger: A Different Path in Fighting Fed’s Ways*, AM. BANKER, Jan. 18, 1988, at 7 (quoting Seger).

91. See Bart Fraust, *Seidman Opposes Volcker on Risk Plan*, AM. BANKER, Nov. 21, 1985, at 1; see also Alan Wade, *Can They Handle Trouble?*, U.S. BANKER, Feb. 1986, at 28 (noting that Seidman “prefers risk-based insurance to increasing bank capital”).

92. The letters of CAMEL stood for the five components of each bank’s rating: Capital adequacy; Asset quality; Management; Earnings; and Liquidity. The FDIC has since incorporated a sixth element: Sensitivity to market risk. For an overview of what is now known as the CAMELS system, see Fed. Reserve Bank of S.F., *Using CAMELS Ratings To Monitor Bank Conditions*, FRBSF ECON. LETTER 99-19, available at <http://www.frbsf.org/econsrch/wklyltr/wklyltr99/e99-19.html>.

93. Timothy J. Curry, Peter J. Elmer & Gary S. Fissel, *Using Market Information To Help Identify Distressed Institutions: A Regulatory Perspective*, FDIC BANKING REV., no. 3, 2003, at 1, 3.

94. See David Kiley, *FDIC Proposing Risk-Related Premiums*, NAT’L MORTG. NEWS, Sept. 30, 1985, at 5 (paraphrasing then-FDIC Chairman William M. Isaac as saying that “the FDIC’s current ‘CAMEL’ rating system is by far the most reliable rating method available”); see also Catherine Yang, *Numbers Game*, FORBES, Mar. 10, 1986, at 102 (quoting James Marino, the assistant director of research

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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.⁹⁵

Instead of risk-based capital requirements, the FDIC wanted to see risk-based deposit insurance premiums. Previously, the FDIC had levied a 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.⁹⁶ The Chairman of the Senate Banking Committee also backed the FDIC idea.⁹⁷ However, Volcker feared that the FDIC's plan would drain funds from the weakest banks—the very banks that most needed to bolster their capital bases.⁹⁸

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, but it did not share Chairman Volcker's concerns about risk-based deposit insurance.⁹⁹ Testifying to Congress in 1985, Deputy Comptroller Michael Patriarca said that his office did "not oppose a risk-based deposit insurance assessment," although between the two options, it took the position that "a risk-based capital assessment is superior."¹⁰⁰

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

at the FDIC, as saying that if "financial ratios" supplant qualitative measures, "there will be a greater incentive to fudge the books").

95. Barbara A. Rehm, *FDIC Seen as Most Flexible Regulator in Settling Details of Risk-Based Capital*, AM. BANKER, Apr. 22, 1988, at 19 (quoting Frutts); Mary Tobin, *New Regulator Favors More Bank Supervision*, UNITED PRESS INT'L, Nov. 20, 1985.

96. The FDIC released a survey at the time showing that 80% of banks supported its risk-based premium plan. Bart Fraust, *Seidman Opposes Volcker on Risk Plan*, AM. BANKER, Nov. 21, 1985, at 1.

97. Bartlett Naylor, *Volcker To Propose Risk-Based Capital Rule*, AM. BANKER, Sept. 12, 1985, at 1.

98. See Robert D. Hershey, Jr., *Economic Scene: Rating Banks for Insurance*, N.Y. TIMES, Sept. 25, 1985, at D2 (quoting Volcker as saying that risk-based insurance premiums are "too crude to bear th[e] burden" of deterring excessive risk-taking by banks); Bartlett Naylor, *Independent Bankers Plan To Reverse Stand and Oppose Risk-Based Premiums*, AM. BANKER, Mar. 11, 1986, at 1 (noting that "Volcker . . . opposes risk-based insurance"). The Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (codified at 12 U.S.C. § 1811 (2006)), ultimately allowed the FDIC to implement a version of its risk-based deposit premium plan.

99. See Naylor, *supra* note 97 (noting that the "Comptroller of the Currency Robert L. Clarke . . . supported risk-based premiums in principle").

100. *Financial Condition of the Bank and Thrift Industries, Part I: Hearings Before the Subcomm. on Fin. Insts. Supervision, Regulation & Ins. of the H. Comm. on Banking, Fin. & Urban Affairs*, 99th Cong. 163 (1985) (statement of Michael Patriarca, Deputy Comptroller of the Currency).

1970s,¹⁰¹ but central banker dominance at Basel continues. Every committee chairman since 1974 has been a central banker. The Federal Reserve also holds two seats on the committee, while other U.S. agencies have only one.¹⁰² Second, the Fed's proposal was the only one that was compatible with other industrialized economies. Germany, Switzerland, and the United Kingdom already had risk-based requirements,¹⁰³ but more than half of the Basel members did not have permanent deposit insurance funds.¹⁰⁴ Even if the other Basel members had wanted to implement the Seidman plan, they would have lacked 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 1986.¹⁰⁵ In that month, Volcker approached Bank of England Governor Robin Leigh-Pemberton and suggested that the central banks bilaterally compose an Anglo-American plan.¹⁰⁶ These talks led to an agreement between the Fed and the Bank of England in January 1987 that mirrored Volcker's earlier proposals. Central bankers in the United States and United Kingdom then worked "to get other countries on board as soon as possible."¹⁰⁷

In order to convince Japan to comply, the United States and United Kingdom had to make huge concessions that undid any "level playing field" benefits of the Accord. For example, they allowed Japanese banks to count virtually all of their expected after-tax securities gains as capital for the purposes of the Basel requirements.¹⁰⁸ According to a Standard & Poor's report, this meant that Japanese banks would meet the Basel thresholds easily

101. Glenn Patrick Tobin, *Global Money Rules: The Political Economy of International Regulatory Cooperation* 133 (1991) (unpublished Ph.D. dissertation, Harvard University) (on file with author).

102. In 1983, the Fed resisted the FDIC's request for one seat on the committee (when the Fed already had two). It yielded only after Congress demanded accommodation of the FDIC. *See International Bank Lending: Hearing Before the Subcomm. on Fin. Insts. Supervision, Regulation & Ins. of the H. Comm. on Banking, Fin. & Urban Affairs*, 98th Cong. 390 (1983); International Lending Supervision Act of 1983, Pub. L. No. 98-181, 97 Stat. 1284 (codified at 12 U.S.C. § 3911).

103. *See* DANIEL K. TARULLO, *BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION* 42 (2008).

104. *See* Asli Demirgüç-Kunt & Edward J. Kane, *Deposit Insurance Around the Globe: Where Does It Work?* (Nat'l Bureau of Econ. Research, Working Paper No. W8493, 2001), available at <http://www.nber.org/papers/w8493.pdf>.

105. *See* Tobin, *supra* note 101, at 204; John D. Wagster, *Impact of the 1988 Basle Accord on International Banks*, 51 J. FIN. 1321, 1343-44 (1996).

106. *See* Ethan B. Kapstein, *Between Power and Purpose: Central Bankers and the Politics of Regulatory Convergence*, 46 INT'L ORG. 265, 281 (1992).

107. Nathaniel C. Nash, *Similar Standards for Banks Are Set by U.S. and Britain*, N.Y. TIMES, Jan. 9, 1987, at A1.

108. Tamura Kentaro, *A Regulator's Dilemma and Two-Level Games: Japan in the Politics of International Banking Regulation*, 6 SOC. SCI. JAPAN J. 221, 234-35 (1993).

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“unless the [Tokyo] stock market drops substantially.”¹⁰⁹ 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.¹¹⁰ 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.¹¹¹

The Basel Committee agreed to a draft agreement in December 1987 and a final Accord the following July.¹¹² 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 of the day had to agree to it, even though the FDIC didn’t particularly believe in it.”¹¹³ By shifting negotiations from the domestic to the international level, the Fed had limited the options for domestic regulators. Faced with an either-or choice between risk-based capital standards and 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

1. Liquidity Standards

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 for 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 United States for transaction deposits was 12%; among major industrialized nations, only West Germany imposed higher reserve requirements than the United States (see Table 2). The

109. See James R. Kraus, *Won’t Stymie Banks in Japan, S&P Says*, AM. BANKER, June 9, 1988, at 14.

110. Akihiro Kanaya & David Woo, *The Japanese Banking Crisis of the 1990s: Sources and Lessons* 10 (Int’l Monetary Fund, Working Paper No. 00/7, 2000), available at <http://www.imf.org/external/pubs/ft/wp/2000/wp0007.pdf>.

111. See Hal S. Scott, *The Competitive Implications of the Basle Capital Accord*, 39 ST. LOUIS U. L.J. 885, 886-87, 891 (1995) (“A principal reason why the Basle Accord could not appreciably even the competitive playing field between United States and foreign banks arises from what can be called the bailout differential Given that the Japanese and European safety nets are stronger, creditors will demand higher interest rates from United States banks than they do from European or Japanese banks with the same leverage [O]ne might consider whether the Basle Accord has actually made things worse for U.S. banks [because it is more expensive for U.S. banks to raise capital than it is for European and Japanese banks to do so].”).

112. See BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988).

113. Telephone Interview with Robert L. Clarke, Former Comptroller of the Currency (Dec. 1, 2008).

United States 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.¹¹⁴ Thus, U.S. banks incurred an opportunity cost equivalent to the interest that they would have received if they had lent funds instead of holding them in reserve.

Table 2: Legal Reserve Requirements, 1989¹¹⁵

	Transaction Deposits	Term Deposits
Canada	10.00%	3.00%
France	5.50%	3.00%
Japan	1.75%	1.20%
United Kingdom	0.45%	0.45%
United States	12.00%	3.00%
West Germany	12.10%	4.95%

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.¹¹⁶ Moreover, to the extent that regulators use cross-border coordination as a tool to “level the playing field,” differential liquidity requirements would seem to create competitive inequities similar to those generated by differential solvency requirements.¹¹⁷ 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

114. Tobin, *supra* note 101, at 177. The Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 128, 122 Stat. 3765, 3796 (to be codified at 12 U.S.C. § 461), allowed banks to begin earning interest on reserves in October 2008.

115. See Gordon H. Sellon, Jr. & Stuart E. Weiner, *Monetary Policy Without Reserve Requirements: Analytical Issues*, FED. RES. BANK OF KAN. CITY ECON. REV., 4th Q. 1996, at 5, 8.

116. See *supra* text accompanying notes 28-30.

117. See Asli Demirgüç-Kunt & Harry Huizinga, *Determinants of Commercial Bank Interest Margins and Profitability: Some International Evidence*, 13 WORLD BANK ECON. REV. 379, 405 (1999) (finding a “negative relationship between reserves and profitability” in a study of banks across eighty industrialized and developing countries); E.J. Stevens, *Is There Any Rationale for Reserve Requirements?*, FED. RES. BANK OF CLEVELAND ECON. REV., 3d Q. 1991, at 2, 2 (noting that even if other weaknesses in the U.S. banking system were resolved, “many analysts believe that reserve requirements still would impair the international competitiveness of U.S. banks”); see also Michael D. Bordo, Hugh Rockoff & Angela Redish, *The U.S. Banking System from a Northern Exposure: Stability Versus Efficiency*, 54 J. ECON. HIST. 325, 335, 337-38 (1994) (noting that “Canadian banks generally earned higher net returns on equity than American banks” from 1920 to 1980, and that one explanation for this fact is that “U.S. national banks were subject to higher reserve requirements” throughout much of that period).

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requirements” for U.S. depository institutions.¹¹⁸ However, the autonomy costs for the Fed in agreeing to an international liquidity accord are high: the Fed already enjoys free reign 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.¹¹⁹ Thus, although the “missing case” of global liquidity standards conflicts with the externalities hypothesis and the “majority view,” it remains consistent with this Note’s alternative hypothesis of a negative correlation between domestic consolidation and cross-border coordination.

2. Holding Company Standards

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.¹²⁰ 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 I; the Accord applied only to the group’s banking business. However, the Fed announced in August 1988 that it would apply Basel I’s requirements to BHCs in the United States as well as their commercial bank subsidiaries.¹²¹ 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.¹²² As in the case of reserve ratios, this is an instance in which regulatory authority in the United States 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,”¹²³ the Fed was able to forge ahead with its plan because its regulatory authority over BHCs was uncontested. Consistent with the alternative hypothesis—but

118. Bd. of Governors of the Fed. Reserve Sys., *Reserve Requirements*, <http://www.federalreserve.gov/monetarypolicy/reservereq.htm> (last visited May 28, 2010).

119. 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. *See* Tobin, *supra* note 101, at 180-82.

120. *See* Bill Orr, *The Fed Drops the Other Shoe*, A.B.A. BANKING J., Oct. 1988, at 124.

121. *See* David Vesey, *Fed Passes New Capital Requirement for Banks*, UNITED PRESS INT’L, Aug. 3, 1988.

122. *See* John D. Hawke, Jr., Comptroller of the Currency, Remarks to the New York Bankers Association (Apr. 6, 2000), available at <http://www.occ.treas.gov/ftp/release/2000-26a.txt>.

123. *See, e.g.*, Nathaniel C. Nash, *Capital Plan Feared as a Burden on Banks*, N.Y. TIMES, July 15, 1988, at D1.

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.

3. Basel II

In the mid-1990s, the Fed found itself facing constraints from rival domestic regulators once again. In 1996, Fed Chairman 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.¹²⁴ Greenspan’s ideas gained currency overseas. For example, the head of banking 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.”¹²⁵ 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 acknowledged that some regulators had “misgivings about letting financial institutions in effect set their own capital levels.”¹²⁶ A May 1999 FDIC report pointed to “serious deficiencies in the proposals that regulators use the banks’ own internal risk-management models in setting capital requirements.”¹²⁷

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

124. See Alan Greenspan, *What Should Regulators Do?*, 78 J. 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.*

125. See George Graham, *Bankers’ Weight Loss*, FIN. TIMES, Apr. 4, 1997, at 19 (quoting Foot).

126. Eugene A. Ludwig, Comptroller of the Currency, Speech to the Federal Financial Institutions Examination Council Conference on Regulatory Capital (Dec. 12, 1997), available at <http://www.occ.treas.gov/ftp/release/97-111.txt>.

127. Daniel A. Nuxoll, *Internal Risk-Management Models as a Basis for Capital Requirements*, 12 FDIC BANKING REV., no. 1, 1999, at 18, 27.

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endorsement.¹²⁸ Moreover, the Basel II Accord changed the context of interagency bargaining within the United States. What *had* been a three-way fight among domestic regulators (or a four-way fight, if the OTS is included)¹²⁹ 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 2007.¹³⁰ As per the FDIC's insistence, the United States retained elements of the risk-unweighted system that had existed alongside the Basel I rules.¹³¹ But in the end, the Fed achieved its principal objective: switching the largest U.S. banks away from Basel I's "risk-bucket" approach and toward a more sophisticated VaR system.

In sum, this Part has shown that over time, 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 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 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 U.S. 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.¹³² 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 nonbroker-dealer subsidiaries that would engage

128. *The New Basel Accord: In Search of a Unified U.S. Position: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 107th Cong. 84 (2003) (statement of Roger W. Ferguson, Jr., Vice Chairman, Federal Reserve Board), available at <http://www.federalreserve.gov/boarddocs/testimony/2003/20030619/default.htm>.

129. For a summary of OTS views on Basel II, see *Basel II: Capital Changes in the U.S. Banking System and the Results of the Impact Study: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit & the Subcomm. on Domestic & Int'l Monetary Policy, Trade & Tech. of the H. Comm. on Fin. Servs.*, 109th Cong. 11 (2005) (statement of Richard W. Riccobono, Acting Director, Office of Thrift Supervision), available at <http://financialservices.house.gov/media/pdf/051105rr.pdf>.

130. See Press Release, Fed. Deposit Ins. Corp., FDIC Approves Implementation of Basel II Capital Rule (Nov. 5, 2007), available at <http://www.fdic.gov/news/news/press/2007/pr07091.html>.

131. Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp., Remarks at Interanational Centre for Business Information's Riskminds 2007 Summit (Dec. 10, 2007), available at <http://www.fdic.gov/news/news/speeches/archives/2007/chairman/spdec1007.html>.

132. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78a-78ll (2006)).

in off-exchange transactions (such as over-the-counter derivatives deals). This effort 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.”¹³³ Second, the Fed sought to tear down the so-called “firewall” between bank holding companies 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.¹³⁴ The Fed chipped away at the Glass-Steagall firewall throughout the 1980s and early 1990s,¹³⁵ and the coup de grâce came in 1999 when the Gramm-Leach-Bliley Act ended the sixty-six year-old prohibition on commercial banks and securities firms combining with one another.¹³⁶

A decade before the repeal of Glass-Steagall, the United Kingdom’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,¹³⁷ and CFTC Chairwoman Wendy Gramm suggested that her agency would support the plan as well,¹³⁸ but SEC Chairman Richard Breeden rejected the SIB/IOSCO standards, calling the capital requirement a “dangerously low” level.¹³⁹ In February 1993, Breeden skipped the IOSCO session in Trinidad at which regulators had hoped to hash out a capital adequacy agreement.¹⁴⁰

133. See Clifford A. Ball & Hans R. Stoll, *Regulatory Capital of Financial Institutions: A Comparative Analysis*, 7 FIN. MARKETS, INSTS. & INSTRUMENTS 1, 47 (1998).

134. Banking Act of 1933 (Glass-Steagall Act), Pub. L. No. 73-66, § 20, 48 Stat. 162, 188 (stating that “no member bank shall be affiliated in any manner . . . with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution . . . of stocks, bonds, debentures, notes, or other securities”).

135. A succession of Supreme Court decisions in the 1980s interpreted the Glass-Steagall Act to allow banks and bank holding companies to engage in limited securities activities. See *Clarke v. Secs. Indus. Ass’n*, 479 U.S. 388 (1987); *Secs. Indus. Ass’n v. Bd. of Governors*, 468 U.S. 207 (1984). For an overview of legal and regulatory developments that chipped away at the Glass-Steagall firewall, see Keith R. Fisher, *Reweaving the Safety Net: Bank Diversification into Securities and Insurance Activities*, 27 WAKE FOREST L. REV. 123 (1992).

136. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 12 U.S.C., 15 U.S.C. & 16 U.S.C.).

137. See *Regulators Propose Minimum Capital Rules for Securities Industry*, THOMSON’S INT’L BANKING REGULATOR, Feb. 10, 1992, at 1.

138. See Aaron Pressman, *CFTC Officials May Oppose SEC on Capital Standards Issue*, INVESTMENT DEALERS’ DIG., Nov. 23, 1992, at 6.

139. *Securities Regulation: Capital Spat*, ECONOMIST, Oct. 31, 1992, at 76 (quoting Breeden).

140. *IOSCO Again Fails To Reach Agreement on Minimum Capital Standards*, SECURITIES WEEK, Feb. 15, 1993, at 5.

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IOSCO officially ended its effort to negotiate a common capital standard that year.¹⁴¹

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 BHCs, which would let them borrow directly from the Fed and achieve a more secure source of liquidity.¹⁴² If a securities firm selected the BHC option, then the Fed—not the SEC—would become its consolidated supervisor. In a further threat to the SEC’s primacy over the securities sector, 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.¹⁴³ Under the Gramm-Leach-Bliley Act, 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.¹⁴⁴ Initially, all the major investment banks selected this latter option.

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

141. DAVID ANDREW SINGER, REGULATING CAPITAL: SETTING STANDARDS FOR THE INTERNATIONAL FINANCIAL SYSTEM 93 (2007).

142. The securities firms Morgan Stanley and Goldman Sachs exercised this option in September 2008. Andrew Ross Sorkin & Vikas Bajaj, *Shift for Goldman and Morgan Marks the End of an Era*, N.Y. TIMES, Sept. 22, 2008, at A1.

143. See Letter from James E. Gilleran, Dir., Office of Thrift Supervision, to Jonathan G. Katz, Sec’y, Sec. & Exch. Comm’n (Feb. 11, 2004), available at <http://www.sec.gov/rules/proposed/s72103/ots021104.htm> (“The Gramm-Leach-Bliley Act . . . kept the responsibility for supervision of the holding company itself with the OTS or the Federal Reserve Board, depending upon whether the holding company was a SLHC [savings and loan holding company] or a bank holding company.”); cf. *Consolidated Supervision of U.S. Securities Firms and Affiliated Industrial Loan Corporations: Hearing Before the H. Comm. on Fin. Servs.*, 109th Cong. (2007) (statement of Robert Colby, Deputy Director, Division of Market Regulation, Securities and Exchange Commission), available at <http://www.sec.gov/news/testimony/2007/ts042507rc.htm> (“Lehman Brothers, Merrill Lynch and Morgan Stanley also own thrifts that account for 3.3%, 1.7% and 0% of the consolidated assets of each firm respectively.”).

144. The post-Gramm-Leach-Bliley structure for holding company supervision is summarized at GOV’T ACCOUNTABILITY OFFICE, FINANCIAL MARKET REGULATION: AGENCIES ENGAGED IN CONSOLIDATED SUPERVISION CAN STRENGTHEN PERFORMANCE MEASUREMENT AND COLLABORATION 12-14 (2007), available at <http://www.gao.gov/products/GAO-07-154>. The SEC discontinued its consolidated supervision program in September 2008.

starting in 2005.¹⁴⁵ The Fed already exercised consolidated supervisory authority over BHCs, 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.”¹⁴⁶ But other agencies scrambled to obtain “equivalence” recognition from their European counterparts. The SEC opened talks with the United Kingdom’s FSA, as London was the site of the European head offices for the largest U.S. securities firms. The OTS approached the FSA¹⁴⁷ as well as France’s Commission Bancaire (which would ultimately recognize the OTS as an “equivalent” supervisor for the ill-fated insurance giant AIG).¹⁴⁸

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” (“CSE”) 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 United Kingdom’s FSA recognized the CSE arrangement as “equivalent” to its own supervision—thus allowing the five firms to operate in the European Union after the Financial Conglomerates Directive took effect in 2005. As an added (and possibly “unnecessary”)¹⁴⁹ inducement to lure the firms into the CSE program, the SEC allowed firms in the program to calculate their capital requirements on a VaR basis (consistent with Basel II) instead of abiding by longstanding broker-dealer capital rules.¹⁵⁰

145. Directive 2002/87, of the European Parliament and of the Council of 16 December 2002 on the Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate, 2002 O.J. (EC).

146. *U.S.-EU Regulatory Dialogue: Hearing Before the H. Comm. on Fin. Serv.*, 108th Cong. (2004) (statement of Susan Bies, Governor, Federal Reserve Board), available at <http://www.federalreserve.gov/boarddocs/testimony/2004/20040513/default.htm>.

147. The Financial Services Authority determined that the OTS “provides equivalent consolidated supervision” for several U.S. financial institutions, including Ameriprise Financial Group and GE Capital Services. See Press Release, Office of Thrift Supervision, OTS Named EU Coordinating Supervisor of Ameriprise Financial Group Unit Threadneedle Group (Sept. 8, 2006), available at http://www.ots.treas.gov/%5C?p=PressReleases&ContentRecord_id=8738bd85-00fd-42de-a3a9-0918b4aac6e1; Press Release, Office of Thrift Supervision, OTS Named EU Coordinating Supervisor of GE (Dec. 22, 2004), available at <http://files.ots.treas.gov/77454.html>.

148. 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-bf4c-18437165c11f.

149. John C. Coffee, *Analyzing the Credit Crisis: Was the SEC Missing in Action?*, N.Y. L.J., Dec. 5, 2008, available at <http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202426495544>.

150. For an overview of the CSE program, see SEC. & EXCH. COMM’N: OFFICE OF THE INSPECTOR GEN., SEC’S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM (2008), available at <http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-b.pdf>.

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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 2008.¹⁵¹ In September 2008, SEC Chairman Christopher Cox announced that it 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 BHC status). Cox acknowledged that the CSE program “was fundamentally flawed from the beginning because investment banks could opt in or out of supervision voluntarily.”¹⁵²

This criticism may be 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.¹⁵³ 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. Then-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.¹⁵⁴ To fund its operations, the OTS “depend[ed] on fees paid by banks it regulate[d] and compete[d] with other regulators to land the largest financial firms.”¹⁵⁵ The OTS’s own consolidated supervision program did not have *any* specific quantitative capital requirements for holding companies. 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 Note, however, is not *whether* the SEC should have acted differently in establishing the CSE program in 2004, but *why* it acted as it did. More specifically, why did it stymie cross-border coordination at the beginning of the 1990s and spearhead such efforts in the early 2000s?

151. Stephen Labaton, *Agency’s ‘04 Rule: Let Banks Pile Up New Debt*, N.Y. TIMES, Oct. 2, 2008, at A1.

152. Press Release, Sec. & Exch. Comm’n, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), available at <http://www.sec.gov/news/press/2008/2008-230.htm>.

153. See *Consolidated Supervision of U.S. Securities Firms and Affiliated Industrial Loan Companies: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs*, 110th Cong. (2007) (statement of Erik Sirri, Director, Division of Market Regulation, Securities and Exchange Commission), available at <http://www.sec.gov/news/testimony/2007/ts100407ers.htm> (stating that “[o]ver the past twenty years,” the SEC has become “increasingly concerned about the risk that a broker-dealer may fail due to the insolvency of its holding company or an affiliate” and noting that the Commission “undertook a number of initiatives to conduct group-wide risk assessments of financial institutions with significant broker-dealer subsidiaries” after 1990).

154. See Greg Ip & Damian Paletta, *Regulators Scrutinized in Mortgage Meltdown*, WALL ST. J., Mar. 23, 2007, at A14.

155. See Binyamin Applebaum & Ellen Nakashima, *Banking Regulator Played Advocate over Enforcer*, WASH. POST, Nov. 23, 2008, at A1. The SEC, by contrast, relies on congressional appropriations for its funding. See GOV’T ACCOUNTABILITY OFFICE, *supra* note 144, at 14.

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 similarly. 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-coordination 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 United Kingdom’s 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.¹⁵⁶

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,¹⁵⁷ are less vulnerable to runs than are institutions that rely on demand deposits and short-term debt. Moreover, insurers are “generally less

156. One might argue that the EU Financial Conglomerates Directive—not the Gramm-Leach-Bliley Act’s further fragmentation of domestic regulatory authority—was the impetus for the U.S.-U.K. agreement on the consolidated supervision of securities firms. Since the domestic regulatory landscape and the EU rules regarding foreign firms changed at roughly the same time, it is impossible to separate the impact of one factor from the other. What we can say with relative certainty is that *if* the SEC’s move towards cross-border coordination was motivated by the further fragmentation of domestic regulatory authority, then the SEC’s actions were consistent with a pattern of behavior that was also evinced by the Federal Reserve with respect to bank regulation, see *supra* Part II, and by the Treasury Department with respect to insurance regulation, see *infra* Part IV.

157. See *supra* note 30 and accompanying text.

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interconnected” than banks¹⁵⁸ (although the collapse of AIG arguably contradicts this conclusion).¹⁵⁹ 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 derivatives transactions. As a 2002 International Monetary Fund report noted, the simultaneous failure of several reinsurers would suddenly “leave many primary insurers with unhedged . . . exposures,” which might lead the primary insurers to “withdraw[] from capital markets and attempt[] to unwind OTC derivatives hedges and liquidate part of their portfolios in order to return their financial and insurance risk profiles to more desirable positions.”¹⁶⁰ 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;¹⁶¹ by 2008, that figure had risen to 84%.¹⁶²

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 United States is highly balkanized.¹⁶³ With the McCarran-Ferguson Act of 1945, Congress granted insurance regulatory authority to state-level supervisors.¹⁶⁴ However, “[i]ssues of centralization aside, state regulators are quite powerful within their jurisdictions.”¹⁶⁵ 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 United States.¹⁶⁶ Moreover, state insurance agencies typically have a single commissioner, whereas federal agencies generally have multiple-

158. Dirk Heremans, *Financial Regulation and Stability of the Banking System*, in EXPLORATIONS IN FINANCIAL ETHICS 31, 46 (Luc Van Liedekerke, Jef Van Gerwen & Danny Cassimon eds., 2000).

159. *But see* Harrington, *supra* note 30, 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.”).

160. Int’l Monetary Fund, *The Financial Market Activities of Insurance and Reinsurance Companies*, in GLOBAL FINANCIAL STABILITY REPORT 21, 46 (2002), available at <http://www.imf.org/external/pubs/ft/gfsr/2002/02/pdf/chp3.pdf>.

161. *See* Debra J. Hall, *US Reinsurance Regulation: A Reinsurance Market Perspective* 5 tbl.3 (2000) (unpublished manuscript), available at http://www.regulatoryandriskconsultants.com/uploads/US_Reinsurance_Regulation.pdf.

162. *See supra* note 34 and accompanying text.

163. *See* SINGER, *supra* note 141, at 104.

164. *See* Martin F. Grace & Michael M. Barth, *The Regulation and Structure of Nonlife Insurance in the United States* 10 (World Bank Fin. Sector Dev. Policy Research, Working Paper No. 1155, 1993).

165. *See* SINGER, *supra* note 141, at 104.

166. *See* Martin F. Grace & Richard D. Phillips, *Regulator Performance, Regulatory Environment and Outcomes: An Examination of Insurance Regulator Career Incentives on State Insurance Markets*, 32 J. BANKING & FIN. 116, 117, 129-30 (2008).

commissioners.¹⁶⁷ Thus, state insurance supervisors enjoy greater individual autonomy to set rules than federal financial regulators.

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.¹⁶⁸ Although the 2009 Treasury White Paper does not incorporate this proposal, it would establish an office within the Treasury Department that would be authorized to "negotiate international agreements . . . and coordinate policy in the insurance sector."¹⁶⁹ Senator Dodd of Connecticut incorporated a strengthened version of the White Paper proposal into his financial reform bill. The Dodd proposal would allow the Treasury Department to preempt state insurance regulations that conflict with international insurance accords.¹⁷⁰ State insurance commissioners vigorously lobbied lawmakers to defeat the Dodd proposal,¹⁷¹ but the final version of the legislation allows the Director of the Federal Insurance Office, a new sub-agency within Treasury, to render a state insurance measure null and void if it is inconsistent with an international agreement that the Treasury Department and the U.S. Trade Representative have negotiated.¹⁷²

It is too early to tell whether the Treasury Department 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 (including officials in the Bush and Obama Treasury Departments) are also the regulators who face the lowest domestic autonomy costs (since Treasury had almost *no* authority over the insurance sector before the Dodd-Frank Act). Meanwhile, the fiercest opponents of the expanded Treasury Department powers are state officials,¹⁷³ 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

167. *Id.*

168. See U.S. DEP'T OF THE TREASURY, *supra* note 16.

169. See U.S. DEP'T OF THE TREASURY, *supra* note 5, at 13.

170. See *Efforts To Change Insurance Provisions in Dodd Bill Face Uphill Battle*, INSIDE U.S. TRADE, May 14, 2010, at 9.

171. See Silla Brush, *Merkley Backing a Push To Give States Strong Powers To Regulate Insurance*, THE HILL (May 3, 2010, 7:27 PM), <http://thehill.com/business-a-lobbying/95767-merkley-wants-states-to-regulate-insurance>.

172. See Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 313(f)(1)(B), 124 Stat. 1376, 1583 (to be codified at 12 U.S.C. § 5412) (granting the Treasury Department authority to preempt state measures that are "inconsistent with a covered agreement"); *id.* § 313(r)(2) (defining "covered agreement").

173. See Press Release, Nat'l Ass'n of Ins. Comm'rs, Regulators and Reform: NAIC Shares Recommendations with Congress (May 19, 2010), *available at* http://www.naic.org/Releases/2010_docs/regulators_and_reform.htm.

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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 autonomy.

Conclusion

This Note 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 (for example, on liquidity regulation and holding company rules), but 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 approach to 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 stimulating 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 early to tell whether the Treasury Department will succeed in negotiating international insurance agreements, the story so far suggests that the advocates for more extensive cross-border coordination are the regulators who will face low autonomy costs, whereas the regulators who resisted the Dodd proposal 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. Thus, contrary to the conventional wisdom, more consolidation will likely lead to *less* cross-border coordination.¹⁷⁴ Does this

174. Although this Note has only addressed the intersection of international financial governance and the U.S. domestic regulatory landscape, there is some evidence that Japanese regulators have also used international agreements as a mechanism to gain leverage vis-à-vis domestic rivals. *See, e.g.,* Colomatto & Macey, *supra* note 61, at 944 (stating that in the Basel I process, “Japanese bureaucrats were able to collude with bureaucrats from other countries in order to obtain more discretionary regulatory authority”); Kentaro, *supra* note 108, at 222 (noting that during the Basel I process, the Japanese Ministry of Finance “used foreign pressure to pursue its domestic goal of

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.”¹⁷⁵ Since it was these vehicles that ultimately proved to be the undoing of Lehman Brothers¹⁷⁶ (and nearly Citigroup as well),¹⁷⁷ the case can be made that the Basel Accords actually contributed to the current crisis.¹⁷⁸ 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 United Kingdom’s FSA). Although the historical record strongly suggests that regulatory fragmentation will 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.¹⁷⁹ At the same time, consolidation creates the risk of “capture of the

legislation for capital adequacy rules”); see also H. Richard Friman, *International Pressure and Domestic Bargains: Regulating Money Laundering in Japan*, 21 CRIME, LAW & SOCIAL CHANGE 253 (1994) (suggesting that the Japanese Ministry of Finance used cross-border coordination as a means of overcoming Postal Ministry resistance to stringent money laundering regulations).

175. Asli Demirgüç-Kunt & Luis Servén, *Are All the Sacred Cows Dead? Implications of the Financial Crisis for Macro- and Financial Policies*, WORLD BANK RESEARCH OBSERVER ADVANCED ACCESS, Feb. 4, 2010, at 103. Specifically, critics of Basel target the so-called “recourse rule,” an amendment to the initial Basel Accord, that allowed a bank to carry \$2 in capital for \$100 in AA- or AAA-rated mortgage-backed securities, whereas the bank would have had to carry \$5 in capital for every \$100 in unsecuritized mortgage loans and \$10 in capital for every \$100 in corporate loans. See Jeffrey Friedman & Wladimir Kraus, *A Silver Lining to the Financial Crisis: A More Realistic View of Capitalism* 4 (Am. Enter. Inst. for Pub. Policy Research, Regulation Outlook No. 1, 2010), available at <http://www.aei.org/docLib/01-2010-Regulation-g.pdf>.

176. See Louise Story & Eric Dash, *Lehman Channeled Risks Through ‘Alter Ego’ Firm*, N.Y. TIMES, Apr. 12, 2010, at A1.

177. See Tracy Alloway, *Citi’s Super-Safe CDOs? Puh-lease*, FT.COM, Apr. 8, 2010, <http://ftalphaville.ft.com/blog/2010/04/08/197766/citis-super-safe-cdos-puh-lease>.

178. See Demirgüç-Kunt & Servén, *supra* note 175, at 103 (“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 175, at 1 (“Powerful evidence suggests that the recourse rule, and other variants of Basel regulations on commercial banks’ capital, caused the crisis.”).

179. See, e.g., Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 13 (1977).

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regulatory mothership.”¹⁸⁰ Whereas oversight lapses at the OTS only affected a small fraction of U.S. banks¹⁸¹ (and one very large insurer¹⁸²), 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);¹⁸³ however, the Fed (and particularly its New York branch) also has a historically cozy relationship with the money center banks.¹⁸⁴ FDIC Chairwoman Sheila Bair has won admirers¹⁸⁵ as a result of her crusading approach to regulation;¹⁸⁶ however, the FDIC has less experience than the Fed and the OCC in overseeing complex multinational financial institutions such as the large investment banks.¹⁸⁷

This Note does not seek to resolve the debate over regulatory consolidation. In deciding whether to consolidate regulatory responsibilities in a particular agency, we must weigh the pros and cons carefully, and the balance may be close. Several commentators have suggested that balance should tip in favor of regulatory consolidation because consolidation will facilitate cross-border coordination.¹⁸⁸ 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 nonexistent “benefit.”

180. See Ilya Podolyako, *Capturing the Regulatory Mothership*, THE BASELINE SCENARIO (May 17, 2009, 2:37 PM), <http://baselinescenario.com/2009/05/17/guest-post-capturing-the-regulatory-mothership>.

181. See *supra* note 84 and accompanying text.

182. See Hugh Son & Margaret Chadbourn, *OTS ‘Fell Short’ Regulating AIG Credit Swaps*, Polakoff Says, BLOOMBERG (Mar. 5, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aDm4OdFvcWUw&refer=home>.

183. See GOV’T ACCOUNTABILITY OFFICE, *supra* note 144.

184. See, e.g., Eliot Spitzer, *Fed Dread*, SLATE (May 6, 2009), <http://www.slate.com/id/2217811>.

185. See, e.g., Jim Cramer, *We Need Sheila Bair*, BLOGGINGSTOCKS (Dec. 4, 2008, 9:18 AM), <http://www.bloggingstocks.com/2008/12/04/cramer-on-bloggingstocks-we-need-sheila-bair>; Matthew Goldstein, *In Praise of Sheila Bair: Financial Regulator Who Gets It*, SEEKING ALPHA (Aug. 14, 2009), <http://seekingalpha.com/article/156132-in-praise-of-sheila-bair-financial-regulator-who-gets-it>; Chris Isidore, *Buffett: My Fix for the Economy*, CNNMONEY.COM (Oct. 2, 2008, 4:44 PM), <http://money.cnn.com/2008/10/02/news/newsmakers/buffett.fortune/?postversion=2008100214> (quoting Warren Buffett as saying that “[i]n my book [Bair] stands higher than any CEO I know of in America today”).

186. See, e.g., Zachery Kouwe, *Sheila Bair Is One Tough Cookie*, DEALBREAKER (Apr. 16, 2010, 1:24 PM), <http://dealbreaker.com/2010/04/sheila-bair-is-one-tough-cookie>.

187. See Peter J. Wallison & David Skeel, *The Dodd Bill: Bailouts Forever*, WALL ST. J. ONLINE, Apr. 7, 2010, <http://online.wsj.com/article/SB10001424052702303493904575167571831270694.html> (“[T]he FDIC is completely unequipped by experience to handle the failure of a giant nonbank financial institution.”).

188. See *supra* text accompanying notes 8-20.