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RESEARCH SUMMARY

EVALUATING THE CENTRALIZED-LAYERS APPROACH TO US FEDERAL FINANCIAL REGULATION

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Since the 1930s Congress has responded to successive crises by creating successive layers of centralized federal regulatory oversight of the US financial system. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) added yet another layer of regulatory responsibility through the Financial Stability Oversight Council (FSOC), a committee made up primarily of heads of various federal agencies with supervisory responsibilities over different functions of financial firms. In his paper "Evaluating the Centralized Layers Approach to U.S. Federal Financial Regulation," David VanHoose evaluates the structure of FSOC and concludes that centralizing regulatory functions, which could be potentially beneficial by streamlining the regulatory process, is more likely to be harmful due to centralization of power and the lack of transparency, clear rules, and observable goals.

Below is a brief summary of VanHoose's paper. To read it in its entirety and learn more about the author, see "Evaluating the Centralized Layers Approach to U.S. Federal Financial Regulation."

SUMMARY

In 2010 Congress changed the operation of bank regulation in the United States when it passed the Wall Street Reform and Consumer Protection Act (Dodd-Frank) by requiring greater coordination among regulatory agencies. Prior to Dodd-Frank's passage, financial regulators were mostly operating independently of each other, regulating banks and other financial firms and overseeing financial activities performed by nonfinancial companies. Under Dodd-Frank, Congress required all these regulators to operate as a single council that can overrule individual members. The secretary of the Treasury heads this large council while together the Department of Treasury and Federal Reserve hold the greatest share of both responsibilities and power. The chairs of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) also have positions on the council.

While some of these reforms may be beneficial, there are also reasons to suspect they could prove deeply problematic.

On the positive side, these changes may remove duplicative regulatory responsibilities as agencies improve communication with one another. Coordination among agencies may remove incentives for financial supervisors to compete to attract clienteles of regulated institutions by weakening their rules

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and standards. Reducing these incentives could also reduce risks to taxpayers by limiting the chance that insolvent financial institutions will have to be bailed out at taxpayer expense.

Unfortunately, the new changes may also be problematic for the following reasons:

- Centralization of decision making within one council makes it far more likely that one or two mistaken regulatory decisions could ripple to harm the entire US financial system, instead of remaining confined within just one sector.
- Concentration of power may also make it easier for regulated businesses to sway rules in their favor. With fewer people to influence, a phenomenon known as "regulatory capture," where agencies serve the interests of the industry they regulate rather than those of the public generally, becomes more likely.
- The new regulation grants regulators discretion to set rules on an ad-hoc basis and pushes the United States even further from a rules-based system. A rules-based system with publicly understandable and observable goals is necessary to create the certainty and predictability that are essential for investment, prudent risk-taking, and growth.
- Dodd-Frank's reticence to push regulators to rely on market-based data in formulating and pursuing supervisory objectives increases regulators' reliance on command-and-control policies divorced from the disciplining function of markets.
- Dodd-Frank removes the stability that could emerge from a system where multiple regulators operate on nearly equal footing.

CONCLUSION

Placing the major federal bank supervisors within the FSOC rulemaking superstructure eliminates some duplicative regulatory activities and reduces the likelihood for a competitive race to the bottom in supervisory quality. These gains, however, are achieved at the sacrifice of gains from regulatory specialization and competition. While integrating regulatory activities within the FSOC may further reduce the potential for a race to the bottom by supervisory agencies, giving a single regulatory body joint responsibility across all financial regulatory functions contributes to the potential for regulatory capture. On net, therefore, greater centralization of regulatory functions within the FSOC has ambiguous effects on the overall quality of US financial regulation.

With respect to several other recommendations of basic economic analysis—to limit supervisory discretion, to pursue regulatory goals in terms of publicly available information and market-based data, to keep regulators focused on key goals via incentive-based contracts, and to ensure coequal status of different agencies to reduce the potential for capture—the Dodd-Frank Act's structural changes take us in the wrong direction.