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**before the Committee on Homeland Security and Governmental Affairs**
**United States Senate**

**Hearing on Financial Regulatory Lessons from Abroad**

**21st May 2009**

My name is David Green. I give testimony as a private individual, drawing on my work experience at the Bank of England, UK Financial Services Authority and UK Financial Reporting Council, and as co-author with Sir Howard Davies of a book entitled "Global Financial Regulation: The Essential Guide (Polity Press 2008). The views I express here are entirely my own and not those of any of the organisations with which I have been associated.

There is remarkable bio-diversity in arrangements for financial regulation at a global level, with no two G7 countries having quite the same structure. There are essentially four main types of structure to be found, with multiple variants. There is the sectoral type, with separate regimes for banking, securities and insurance, which can be found in eg France, Italy or Spain. There is the so-called "twin peaks" type to be found in Australia or, in alternative versions, in The Netherlands or Canada; the integrated type, versions of which can be found in Germany, Japan and Scandinavia, as well as the UK; and a fourth type, which might be described as "other", of which the prime example is the US, with its extraordinary complex of agencies at both state and federal level. In each case the central bank may or may not have responsibility for some, many or all aspects of supervision.

Although integrated regulators have existed in a number of countries for several decades, the creation of the FSA in 1998 produced perhaps the most advanced form of that model, although variants of the integrated regulator model continue to be introduced and are now in place in more than forty countries. By "integrated" I mean a regulator that deals with banking, insurance, asset management and market supervision and regulation, all within a single agency. This is by comparison with arrangements whereby there are completely separate agencies dealing with each of these sub-sectors or with the "twin peaks" model, under which there is partial integration, usually with a separation between, on the one hand, the safety and soundness regulation, or what in the UK we call the prudential regulation of banking and insurance and, on the other, conduct of business regulation, usually, though not always, solely in relation to securities and investment business.

The FSA was created remarkably rapidly when the incoming Labour Government decided in 1997 that, at the same time as giving the Bank of England independence in the implementation of monetary policy, it would also create a single regulator for financial services. At the time no systematic review had been undertaken of what was needed and some of the factors leading up to the decision were of purely local, national concern, arising, for instance, from a previous unsatisfactory and duplicative structure in the regulation of investment services and partly from perceived shortcomings believed to arise from the location of banking supervision in the central bank. Indeed, the rationale behind creating an integrated regulator was only fully developed in the course of the FSA's creation.

The merger that was set in train, and which eventually comprised 11 organisations, also involved the drafting of a single piece of comprehensive legislation. This new legislation incorporated fresh thinking about the ultimate objectives of financial regulation and the principles that should guide its exercise. Not all integrated regulators operate with a single integrated piece of legislation, but instead maintain separate sectoral legislation while still placing the management of the staff who undertake the regulation under a single roof in order to promote co-ordination, consistency and efficiency.

In the UK case, the merger of the staff was undertaken in practical terms within an eighteen-month period, but the implementation of the legislation followed almost three years later. In the meantime, the form of the old legislation was observed, while the substance of the new body was being planned and implemented. No significant part of the infrastructure of any one of the existing regulators was used for the new body, as it would have created the impression that one body was taking over the others. A key success factor for the new organisation was identified at the outset as being the creation of something built organically by its members and it was not possible to identify the pre-existing regulators within the new structure once it was completed.

In the period following the establishment of the FSA, it published a member of papers setting out the rationale for integrated regulation.

The main arguments advanced were as follows: -

1. The growth of financial conglomerates undertaking a range of banking, insurance and investment businesses poses a challenge to sector-based regulation. The growth in the number of financial conglomerates has been accompanied by a blurring of the boundaries between products, and channels of distribution are no longer as specialised as they once were. It is now difficult to regulate on a functional basis, since a traditional functional approach no longer matches the structure of either firms or markets.

2. This points to a need for regulatory oversight of a financial conglomerate as a whole since there may be risks arising within the group that are not adequately addressed by any of the specialised supervisory agencies that undertake their work on a solo basis.

3. It is possible to solve this problem through a lead regulator approach, whereby one agency takes responsibility for the co-ordination of the work of others, but a single regulator offers a number of advantages. In particular, it ought to be able to generate a number of efficiency gains; there are economies of scale and scope because a single regulator can, as well as utilising a single set of support services, also unify statistical reporting and construct a consolidated set of rules and guidance.

4. Integration of the regulatory functions makes it possible to align the regulatory structure with the way the firms manage themselves. This should help with the proper understanding of the overall business model and of its risks. Earlier experience pointed to instances where the divide between conduct of business and prudential regulation was unhelpful to understanding the complete picture.

5. A regulated firm only needs to deal with one agency for all its regulatory business, ideally through relationship managers on both sides.

6. In addition to scale economies, a single regulator ought to be more efficient in the allocation of regulatory resources across both regulated firms and types of regulation. This requires a risk-based approach to supervision under which resources are devoted to those firms and areas of business that from time to time are seen as posing the greatest risk. This allocation and reallocation of resources to deal with changing demands can be more actively undertaken within a single authority, though it requires continuous attention to make sure emerging risks are not neglected.

7. A single regulator ought to be best able to resolve efficiently and effectively the conflicts which inevitably arise between the different objectives of regulation. These are generally taken to be prudential soundness and the maintenance of confidence, on the one hand, and transparency and consumer or investor protection on the other. This approach does not deny that tensions or even conflicts may exist, but argues that these tensions have to be resolved in one way or another. This needs to be done both at the regulator level and also within a firm. A breakdown in consumer protection, whether in banking, investment or insurance products, may itself precipitate a wider loss of confidence in types of product or types of firm. A failure to understand the financial implications of the structure of particular products can also threaten safety and soundness. In the long run, these two aims are aligned. The UK had already had experience of problems arising from the uncoordinated pursuit of objectives by regulators when they were separated, which in one case may have led to the unnecessary failure of a bank. Recent experience also suggests that conflicts have had to be settled in countries where the responsibilities are separate in

ways that have led to one or other of the regulators effectively suspending pursuit of their responsibility until a resolution was reached.

8. A single regulator strengthens accountability. It can be made solely responsible for its performance against statutory objectives, for the regulatory regime, for the cost of regulation and for regulatory failures.

Clearly, another set of issues is related to the decision to remove responsibility for banking supervision from the central bank. The arguments against combining monetary policy and banking supervision included:-

1. There might be a conflict of interest which tempted a central bank to loosen its monetary policy stance (or to delay a monetary tightening) because of concerns about the financial health of the banks it regulates.

2. A loss of credibility arising from perceived regulatory failings may damage the central bank's reputation, and therefore its authority to conduct monetary policy.

3. The wider role of a central bank and the more it takes on regulatory responsibilities which inevitably involve the disposition of property rights, the greater the risk that it would be subject to political pressure or political control which may undermine its independence in respect of monetary policy. It could be difficult to manage two different types of accountability relationship with Government and Parliament within the same institution, namely, independence in respect of the implementation of monetary policy, but accountability in respect of the supervision of banks.

4. There was an argument for the separation of lender of last resort from supervision responsibilities, on the grounds that a lender of last resort which is also responsible for ongoing supervision may be tempted to intervene in support of an institution to cover up the inadequacy of its own supervision. Furthermore, involving two agencies in the decision of whether to rescue an individual institution may improve the quality of decision-making.

5. The putting of banking supervision into the central bank involves the separation of banking supervision from the rest of regulation, depending on which other functions are also included in the central bank, with the comsequent disadvantages outlined earlier.

These points are, in comparative terms, more difficult to substantiate than the arguments in favour of the integration of the different supervisory disciplines.

Given the decision to create an independent integrated regulator and to leave the implementation of monetary policy with the central bank, another key element in the UK arrangements was a tripartite Memorandum of Understanding setting out the roles of each of the FSA, Bank of England and Treasury. This acknowledged the different functions of the regulator, the central bank as monetary policy-maker and manager of last resort lending, and Treasury as provider of fiscal support and, in the UK context, ultimate proposer of legislation.

The FSA structure is not entirely comprehensive in that it does not encompass the regulation of pensions, where a new regulator had recently been established, and with most pension funds closely linked to non-financial employers. Nor does it incorporate corporate reporting.

The main elements in corporate reporting were progressively brought under the separate single roof of the Financial Reporting Council over more than a decade. Unlike in the case of the FSA, the legislation for the different elements of the regulation of corporate reporting have not been integrated and they remain the responsibility of formally independent decision-making boards, not all with full statutory authority, but served by a single secretariat and with one over-arching board.

The functions housed under the Financial Reporting Council roof are the maintenance of the non-statutory corporate governance code, the setting of accounting, auditing and actuarial standards, the public oversight and inspection of the auditing and actuarial professions and the related exercise of enforcement and discipline. [A full account of how these arrangements work can be found in the FRC's Regulatory Strategy, to be found on the FRC's website, www.frc.org.uk]. Although there is no statutory objective for the constituent operating bodies under the Financial Reporting Council to seek to implement an integrated regulatory approach, the fact of being under a common roof supports the adoption of mutually consistent approaches where this is appropriate. The FRC model has not been precisely replicated in any other country, but has attracted a lot of interest, including in the US.

I have been asked to comment on how the integrated model has stood the test of time in the UK. In the period up to the start of the financial crisis in 2007, the UK model was widely praised both domestically and internationally. Since the onset of the crisis regulation in the UK has been widely criticised, as it has been in the US and elsewhere. Some of those criticisms have in effect been targeted at the international rules on bank capital; others have been related to other causes, including the structure of regulation. Some have argued that the separation of banking supervision from the Bank of England was a mistake, reducing the central bank's understanding of banking and financial markets.

The FSA has acknowledged in the case of the failed bank, Northern Rock, that it did not always do what it was supposed to do, or even follow its own internal procedures, and it has published probably the most comprehensive report by any authority anywhere so far in the crisis about how this happened and what it will do to prevent similar shortcomings in the future.

There have been shortcomings in analysis and failure to understand the full implications of changing market structures and changing business models, but failure either to fully understand the implications or to act on such analysis has been a feature of each of the different regulatory models. The FSA has also produced its own review on how to respond to these shortcomings [The Turner Review-A Regulatory Response to the Banking Crisis. March 2009. www.fsa.gov.uk]. And there have been failures of communication between the regulator, central bank and government. This has been much discussed, although no definitive analysis has been produced.

The main structural lesson to be drawn has been that the FSA needs to be more alert to wider developments in the economy and in markets as they affect the firms it regulates, and that the central bank needs to be more alert to developments in the financial system as the financial system is the only medium through which monetary policy is transmitted to the economy. Some have argued in an imprecise way for banking supervision somehow to be separated out of the FSA and returned to the central bank, but this has not received serious, considered support.

In short, the crisis has not generated any serious questioning of the integrated model. Indeed, it has illustrated rather clearly the interlinkages between banking, investment and securities, which was one of the prime causes of the creation of the FSA. Both the Bank of England and the FSA [see eg Turner Review pp 89-92] have examined the question as to which kind of regulatory model performed best internationally under the stress of the present crisis, but have found no pattern in the outcomes. Just to take a small number of examples, both Spain and Canada have been relatively successful in weathering the crisis, yet Spain operates sectoral supervision, with banking supervision located in the central bank, while Canada has an integrated prudential regulator with no central bank involvement. In contrast, both the UK and the US underwent considerable difficulty, with the FSA operating an integrated regime outside the central bank, but the US entrusting a major sectoral role in banking supervision to the Federal Reserve.

It has been suggested that I comment on proposals for reform in the US. The new Administration has yet to fully set out its own proposals for reform so that former Secretary Paulson's blueprint remains the most closely articulated model. Clearly, the existing structure derives from the very distinctive historic and political background to the evolution of regulation in the US, including notably the federal structure. Having local and state levels of responsibility and accountability brings its own strengths. Nonetheless, viewed from outside, there seems clear need for major reform. The Paulson blueprint addresses the most evident anomalies; the absence of a federal structure for insurance supervision and the division of competence in the securities and derivative markets between the SEC and CFTC.

As has been widely commented, the Paulson blueprint appears to have closest resemblance to the Australian model. Clearly the arguments referred to earlier about whether to integrate conduct of business and prudential regulation are relevant here and others, such as Prof. Howell Jackson of Harvard, have argued instead for a rapid move to a fully integrated structure of regulation, very much for the motives outlined earlier [Howell E. Jackson. A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States. London School of Economics Financial Markets Group Special Paper 184].

The most imprecise part of the Paulson blueprint seems to be the separation between the Federal Reserve's role in relation to systemic risk and that of the functional regulators. While it is possible, indeed desirable, to undertake analysis of system-wide issues - so-called macro-prudential analysis –, supervision only takes place at the level of each individual firm or market. It would make for confusion if the systemic agency became responsible for matters that overlapped with the responsibilities of the functional regulator, whether prudential or conduct of business, and this would need to be resolved. One way of resolving this could be to create an integrated regulator just for systemic firms, perhaps building along the lines foreshadowed recently by Secretary Geithner, but that would then raise level playing field and efficiency issues in relation to the regulation of non-systemic firms for which some further mechanism would be needed.

A single regulator for the US financial market on the UK model would be both an extremely large and an extremely powerful institution, perhaps too powerful in the US political context. It is also difficult for an outsider to comment on how best to deal with the overlapping jurisdiction of federal and state governments. Clearly, there are very many major issues over jurisdiction, both between the federal government and the states, and within the Congress itself. Nevertheless, the outside observer is inclined to feel that there must be substantial costs to the US economy in these arrangements, which even partial rationalisation would mitigate. Both gaps and overlaps are important and the proposition advanced recently by the administration that regulation should focus on what financial firms do and no longer on the legal form they take in order to determine who will regulate them makes a fundamental point in relation to regulatory reform. This proposition is advanced in the context of creating a single regulator with responsibility over systemically important firms, but it would make a sound starting point for reform in financial regulation as a whole.

Thank you for your attention. I look forward to seeking to respond to your questions.