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To the

Senate Committee on Banking, Housing and Urban Affairs

Strengthening and Streamlining the Federal Supervision of Financial Institutions

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Thank you Chairman Dodd, Ranking Member Shelby and members of the Committee for asking me to discuss with you the reform of federal regulation of financial institutions

I would like to share with the Committee my thoughts on consolidation of the federal financial regulatory agencies and what it would take to make them successful in the future. However, this is part of a larger puzzle – the reorganization of federal financial regulation generally and, in some respects, it is difficult to discuss the narrower topic without examining the broader context. I will therefore also say something about possible complementary changes in the roles of the Federal Reserve, the SEC and the proposed CFPA.

A summary of my testimony today is as follows:

- The best framework to guide current reform efforts is an objectives approach that divides regulation up into micro-prudential, macro-prudential and conduct of business regulation. .
- The quality of regulation must be improved regardless of where it is done. Regulatory and supervisory agencies must have better qualified, better trained and better paid staff with clear objectives to improve safety and soundness and encourage innovation. Regulatory personnel must be accountable for their actions.
- A single federal micro prudential regulator should be created combining the regulatory and supervisory functions currently carried out at the Fed, the OCC, the OTS, the SEC and the FDIC. This regulator should partner closely with state regulators to ensure the safety and soundness of state chartered financial institutions, sharing supervisory authority.
- The US needs effective conduct of business regulation. The SEC is currently charged with protecting shareholders and the integrity of markets and must improve its performance in this area. In my judgment, the SEC should also create a new division within the agency to protect consumers, that is to say, it would add a CFPA division and become the consolidated conduct of business regulator. Although my first choice is for a single conduct of business regulator, a well-designed standalone CFPA could also be effective.
- The Fed should be the systemic risk monitor with some additional regulatory power to adjust lending standards. In this it should work with a Financial Services Oversight Council, as has been proposed by the Treasury.

The Objectives Approach to Regulation

I support an objectives-based approach to regulation.

The Blueprint for financial reform prepared by the Paulson Treasury proposed a system of objectives-based regulation, an approach that is the basis for successful regulation in Australia and other countries overseas. The White Paper prepared by the Geithner Treasury did not use the same terminology, but it is clear from the structure of the paper that their framework is an objectives-based one, as they lay out the different elements of regulatory reform that should be covered. However, they do not follow through the logic of this approach to suggest a major re-organization of regulatory responsibilities.

There are three major objectives of regulation:

- First is the micro-prudential objective of making sure that individual institutions are safe and sound. That requires the traditional kind of regulation and supervision – albeit of improved quality.
- Second is the macro-prudential objective of making sure that whole financial sector retains its balance and does not become unstable. That means someone has to warn about the build up of risk across several institutions and take regulatory actions to restrain lending used to purchase assets whose prices are creating a speculative bubble.
- Third is the conduct of business objective. That means watching out for the interests of consumers and investors, whether they are small shareholders in public companies or households deciding whether to take out a mortgage or use a credit card,

An objectives-based approach to regulation assigns responsibilities for these three objectives to different agencies. The result is clear accountability, concentration of expertise, and no gaps in coverage of the financial services industry -- even as its structure changes and new products, processes and institutional types emerge. No other way of organizing regulation meets these important criteria while avoiding an undue concentration of power that a single overarching financial services regulator would involve.[2] The main focus of this testimony will be to make the case for a single micro prudential regulator, something I believe would enhance the stability of the financial sector. Having a single micro prudential regulator is not a new idea. In 1993, the Clinton Administration and the Paulson Blueprint in 2008 proposed the same thing.

It is important to remember that how we organize regulation is not an end in itself. Our plan must meet the three objectives efficiently and effectively, while avoiding over-regulation. In addition for objectives-based regulation to work, it is essential to use the power of the market to enhance stability. Many of the problems behind the recent crisis----executive and trader compensation, excessive risk-taking, obscure transaction terms, poor methodologies and conflicts of interest -- could have been caught by the market with clearer, more timely and more complete disclosures. It will never be possible to have enough smart regulators in place that can outwit private sector participants who really want to get around regulations. An essential part of improving regulation is to improve transparency, so the market can exert its discipline effectively.

The Independence of the Federal Reserve

[2] See Pew Financial Reform Project Note #2: Choosing Agency Mandates, by Charles Taylor

In applying this approach, it is vital for both the economy and the financial sector is that the Federal Reserve has independence as it makes monetary policy. Experience in the US and around the world supports the view that an independent central bank results in better macroeconomic performance and restrains inflationary expectations. An independent Fed setting monetary policy is essential.

The Main Regulators and Lessons from the Crisis

The main federal micro-prudential regulators had mixed performance at best during the recent crisis.

OTS did worst, losing its most important institutions – WaMu, IndyMac and AIG – to sale and outright failure. Without any economies of scale in regulation, OTS suffered from a small staff in relation to their supervisory responsibilities. Its revenue was dominated by fees on a very small number of institutions, leading to regulatory capture. And, as many have observed, OTS lax standards attracted institutions to a thrift charter and it because the weakest link in the federal financial depository regulatory chain. The lessons were: regulatory competition can create a de facto race to the bottom; and large institutions cannot be supervised and regulated effectively by small regulators – not only because of the complexity of the task but also because of capture.

The Office of the Comptroller of the Currency (OCC) fared only somewhat better. Their responsibilities were far wider and their resources were far greater. Nevertheless, several of their larger institutions failed and had to be rescued or absorbed. While an element of the problem was that there were parts of these institutions where their writ did not reach -- OCC-regulated banks bought billions of dollars of CDOs, putting many of them into off-balance-sheet entities -- it was not the only problem. Somehow, even this relative powerhouse failed to see the crisis coming. The lessons were: even the best of the federal regulators may not have been up to the demanding task of overseeing highly complex financial institutions; and balkanized and incomplete coverage by micro-prudential regulators can be fatal.

The FDIC is rightly given credit for having championed the leverage ratio as an important tool of policy. While the Fed and the OCC became increasingly enamored of Basel II over the past ten years, the FDIC suffered repeated criticism for their stick-in-the-mud insistence on the leverage ratio. On that issue, they have been vindicated not only here in the US, but internationally. But they did not do so well in prompt corrective actions during this crisis. Their insurance fund dropped from $45bn to $10bn in twelve months. Several of the firms that failed were well capitalized just days beforehand. The lesson is that liquidity and maturity transformation can matter as much as leverage in a crisis. Prompt corrective action focused on capital ratios alone is not enough.

While some state regulators have a fine record, non-bank financial institutions, largely overseen at the state level, were a major source of trouble in the recent financial crisis. Often working with brokers, these institutions originated many of the subprime, prime and jumbo mortgages that have subsequently defaulted. They provided the initial funding for mortgages, but then quickly sold them to other entities to be packaged and securitized into the CDOs that were sliced and diced and resold with high credit ratings of dubious quality. They made money by pushing mortgages through the system and did not carry risk when these mortgages defaulted. Many state regulators failed to control bad lending practices. The main lessons: skin in the game is needed to keep the "handlers" of securitizations honest; and any reform of financial regulation has to somehow strengthen state regulation as well as federal.

Perhaps the most difficult regulator to assess in the current crisis is the Federal Reserve.

More than any other institution, it has prevented the financial system from falling off a cliff through often brilliant and unprecedented interventions during the worst days of the crisis. I have expressed publicly my admiration for the job that Ben Bernanke has done in managing this crisis with Secretary Geithner and others. Taxpayers are understandably angry because of the funds that have been spent or put at risk in order to preserve the financial sector, but the alternative of a more serious collapse would have been much worse. The historical experience of financial crises here in the United States and around the world is that a banking collapse causes terrible hardship to the economy, even worse than the current recession. Bernanke and Geithner have helped avoid that disaster scenario.

However, the Fed did nothing at all for fourteen years to prevent the deterioration in mortgage lending practices, even though Congress had given it the authority to do so in 1994 under HOEPA. Several of the bank holding companies under Fed supervision faced severe problems in the crisis – its micro-prudential regulation was ineffective. And, while the Fed has repeatedly claimed that systemic risk management was their responsibility, they failed to anticipate, or even prepare for, the crisis in any meaningful way.

In short, in its role as a regulator of bank holding companies, the record of the Fed is not good. Bank regulation has been something of a poor relation at the Fed compared to the making of monetary policy. The Fed as an institution has more stature and standing than any other federal financial institution, but this stature comes from its control over monetary policy, not on its role in bank supervision and regulation. In addition, the Fed's powers were limited. It could not gain access to key information from many large financial institutions and had no power to regulate them. Lehman and Bear Stearns are two examples.

While, the Fed has increased its knowledge and understanding of the large banks as a result of managing the crisis and conducting the stress tests, the lessons are: having an institution with a secondary mandate for consumer protection (under HOEPA) does not work well; and the Fed's focus on monetary policy also makes it difficult to direct enough institutional focus on supervision.

Finally, there is the Securities and Exchange Commission which did an abysmal job in this crisis. It told the public that Bear Stearns was in fine shape shortly before the company failed; in fact it failed to supervise effectively any of the bulge bracket firms, Merrill Lynch, Bear Stearns, Goldman Sachs, Morgan Stanley and Lehman). It did nothing to restrain the credit agencies from hyping the ratings of CDOs. And it did not stop Madoff and others from defrauding investors. However, the leadership has changed at the SEC and I believe it has learned important lessons from the crisis: its strong suit is not micro-prudential regulation of institutions; it must focus on investor protection and the integrity of the markets – not only the traditional ones like the stock and bond markets, but also the securitization market – including the development and implementation of policies to revamp securitization credit ratings.

One vital issue to recognize in regulating the large financial institutions is that they are run as single businesses. They decide what their business strategies will be and how to execute them most effectively. The specific legal forms they choose for their different divisions is determined by what they think will work best to achieve their strategic goals, given the tax, regulatory and legal environment that policymakers have set up. Under the current regulatory system, the Fed supervises and regulates the bank holding company while, for example, the OCC supervises the US banks that are the subsidiaries of the holding company. Most of the large financial institutions are in several lines of business and, at present, are regulated by more than one agency. Inevitably, this encourages them to shift activities to the subsidiary and hence the regulator that is most tolerant of the activity they want to pursue. Balkanized regulation is unlikely to stop the next crisis.

This short review is not inclusive. There are credit unions that have a separate regulator and there are important issues around the GSE's and their regulation and around derivatives and their regulation that I will not tackle in this testimony. This review has been critical of the regulatory agencies but I want to note that there are many people to blame for the financial crisis, including bankers who took excessive risks and failed to do due diligence on the assets they purchased. Economists generally did not predict that such a severe crisis was possible. Very few people saw the possibility of a 20 percent or more decline in the price of housing and almost nobody saw the depth of problems that have resulted from the sharp declines in house prices.

What Structure Best Meets the Objectives of Financial Regulation?

Regulatory Performance Must be Improved Regardless of Where it is Done.

There must be improved performance in the supervision and regulation of financial institutions regardless of who is doing it. There were rooms full of regulators sitting in all of the large regulated financial institutions prior to the crisis and they failed to stop the crisis. This means there should be more accountability for regulators, so that they are censured or removed if they do not perform the role they were hired to do. It means they should be better paid. It seems paradoxical to reward a group that did not do so well historically, but if we want better regulators then they must receive salaries that make their jobs attractive to high quality people, those who can understand complex institutions and products and who may have the option of earning high incomes in the private sector. Adequate training must be available. Better quality regulation is a "must-have" of financial reform and must be part of the legislation now being considered. A lot of improvement can be made even under existing legislation if regulators have the incentives and abilities to do their jobs.

Some people argue that regulation has been the cause of the problem and that if the government were removed from the equation then the financial sector would regulate itself, with weak companies failing and the strong companies surviving. Overall, I am a strong supporter of letting markets work and letting companies fail if they cannot be efficient or innovative. This includes financial institutions that should be allowed to fail if they do make bad decisions and fail to meet the market test. The financial sector has unique features that make it different from most other industries, however. Failure in one institution can spill over to others and problems in the financial sector can rock the whole economy, as we have seen in this crisis. Regardless of one's perspective on this issue, however, it is clearly a mistake to create worst of both worlds. If the government provides a safety net for consumer deposits and props up financial institutions in a crisis, then there must be effective high quality regulation that will protect the interests of taxpayers.

The Case for a Consolidated Micro Prudential Regulator for the Financial Sector.

A single prudential regulator would become a powerful institution with stature in the policy community that could hire talented staff and attract strong and able leadership. It would be formed by drawing together the best people from the existing supervisors and regulators in the OCC, the OTS, the SEC, the FDIC and the Federal Reserve, it would hire financial experts in areas where more expertise was needed, and it would be the primary supervisor of the institutions that make up the financial sector of the United States. The head of the organization would be chosen by the President with the consent of the Senate and would serve for a term of several years. It would be worth considering a structure like that of the Federal Reserve, with a board that served staggered 16 year terms. Thus constituted, the financial regulator would have the standing and capability to stand up to the heads of leading financial institutions and to be an independent arbiter. It would be a partner with and advisor to the Administration, Congress and the Federal Reserve.

The financial sector does not stand still. It evolves and innovates and new institutions and products are born. A single prudential regulator with the necessary staff and skills would be best positioned to evolve along with the industry and adapt regulation to a changing world. Having a single prudential regulator would make it much easier to avoid gaps in regulation and discourage the kind of regulatory evasion that contributed to the crisis. It would also reduce the regulatory burden on financial institutions because it would avoid much of the duplication that now exists.

A single prudential regulator would supervise and regulate large institutions and small and be able to maintain a level playing field for competition. It would be able to examine all of the activities of the large global banks and make sure they were not accumulating excessive risks through a combination of activities in different parts of their business.

There is a great deal to be said for competition in our economy. Ultimately, competition in the private sector drives innovation and growth and provides choices to consumers. It is the lifeblood of our economy. It is not clear, however, that competition among regulators a good thing. The serious danger in regulatory competition is that it allows a race to the bottom as financial institutions seek out the most lenient regulator that will let them do the risky things they want to try, betting with other people's money. One possible advantage of regulatory competition is that it could make it easier for companies to innovate whereas a single regulator might become excessively conservative and discourage new products even if these would bring substantial benefits. However, given the experience of the recent crisis, the dangers created by multiple regulators, including a race to the bottom, are greater and outweigh the possible advantages of competition among regulators.

An effective single prudential regulator acting as a cop on the beat could actually increase the level of effective competition among private companies in the financial sector, thus making the private market work better. In addition, it would be very important that the mandate of the single prudential regulator include the promotion of innovation and economic growth. The US financial sector has been one of the strongest in the world and has been one of our major exporters. Prior to the crisis there was great concern that the New York financial markets were losing their global competitive position—see for example the Bloomberg-Schumer report. The goal of sustaining a dynamic and competitive sector remains vital.

Another advantage of creating a single federal prudential regulator is that it would enhance the independence of the Federal Reserve in making monetary policy. It gets the Fed out of the regulatory business and lets it concentrate on its main tasks.

The Role of the FDIC

With a single micro prudential regulator, the FDIC would lose the supervisory and regulatory authority it has now. Staff from the FDIC that have performed well in this crisis would move to the new prudential regulator, so there would not be a loss of knowledge or expertise. The role of the FDIC as manager and supervisor of the deposit insurance fund would continue. In this position, it would also be able to sound warnings about depository institutions in difficulties, acting as a backup for the new unified prudential regulator. Another possibility is that the FDIC would become the principle agency dealing with the resolution of failing institutions.[3]

The SEC as the Conduct of Business Regulator

[3] I have testified to this committee before on the dangers of "too big to fail" or "too interconnected to fail". An important aspect of regulatory reform is to make sure badly run financial companies are allowed to fail in a way that does not imperil the whole system, either through a resolution mechanism or through a special bankruptcy court. The FDIC would play an important role with either system.

Under the single prudential regulator described above, the SEC would lose its authority to supervise non-bank financial institutions, which would reside instead with the prudential regulator. The SEC would continue to have a very important role as a protector of the interests of shareholders, a bulwark against insider trading, market manipulation, mis-selling and other practices that can undermine our capital markets. There is a case for giving the SEC additional authority to provide consumers protection against financial products that are deceptive or fraudulent.

The Treasury White Paper proposed establishing a new standalone agency, the CFPA, to provide consumer protection and it is understandable that such a proposal is made given what has happened. There were a lot of bad lending practices that contributed to the financial crisis. As noted earlier, many brokers and banks originated mortgages that had little chance of being repaid and that pushed families onto the street, having lost their savings. There was also misbehavior by borrowers, some of whom did not accurately report their income or debts or manipulated their credit scores. I agree with the Administration and many in Congress—notably Chairman Dodd—on the importance of protecting families against a repetition of the bad behavior that proliferated in recent years.

My first choice would be to place the responsibility for consumer protection in a new division within the SEC rather than creating a separate agency. The proliferation of regulators was a contributory factor in the crisis, so that adding a new agency is something that should be done reluctantly. While the SEC did badly in the crisis, there has been an important change in leadership and the new head of the agency is clearly someone of strength and talent who has pledged reform in the operations of the agency. Congress should ask the SEC to form a new CFPA division within its ranks charged specifically with consumer protection.[4]

Placing the tasks of the CFPA into the SEC would create a single strong conduct of business regulator with divisions specifically tasked to protect both consumers and small and minority shareholders. It would also make it easier to gain acceptance for greater consumer protection from the financial industry. The CFPA has become a lightning rod for opposition to regulatory reform. Given that the financial sector is largely responsible for the crisis, it is surprising that this sector is now lobbying so hard against greater consumer protection. Greater protection for consumers is needed and that would also

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[4] The Federal Reserve did not do a good job in protecting consumers in the period leading up to this crisis, nor did it stop the erosion of mortgage lending standards that contributed to build up of toxic assets in the financial system. Since the crisis, however, the consumer protection division within the FED has been strengthened and is now an effective force with strong leadership. The personnel from the consumer protection division of the FED, together with the best personnel in this function in other agencies, could be moved into the new CFPA division.

provide greater protection for taxpayers. However, having the CFPA functions as a division within the SEC would accomplish that goal while calming industry fears.

Having the CFPA functions within the SEC is my first choice, but if Congress decides against this approach, I could support a standalone agency. The Treasury White Paper does a good deal to allay the fears that the new agency would stifle innovation, including: the overall focus on unfair, deceptive, and dangerous practices, rather than risk, per se; the instruction to weigh economic costs and benefits; the instruction to place a significant value on access to financial products by traditionally underserved consumers; the prohibition against establishing usury limits and; the option to consider previous practice in regard to financial products. The Treasury recognizes the dangers of having an agency that would over-reach and its proposed structure would avoid that possibility.[5]

One final issue with the CFPA is pre-emption. The Treasury proposal indicates that state regulators would have the power to enact consumer protection legislation that was stronger than that in the federal statute. I understand the case for states' rights in this arena, but the prospect of a myriad of different state rules is daunting and has the potential to reduce the efficiency of the massive US marketplace. There has been enormous progress towards a single market in financial products, leveling the playing field for businesses and consumers, so that the terms of loans or other financial activities are the same in all states. Whether or not federal consumer protection rules pre-empt state rules is not a major issue for safety and soundness, but having single set of consumer rule uniform in all states would improve economic efficiency. As a result, I support the view that federal rules should pre-empt state rules in this area.

Regulating State Chartered Financial Institutions

Starting with a clean sheet of paper, I would prefer to see all banks and relevant non-bank financial institutions have federal charters and be supervised by the unified prudential regulator. However, that is not the situation we are in and I recognize the importance of states' rights and the desire to have local institutions that can help local businesses by using the power of personal knowledge and relationships. It is a fact of life that there will continue to be state chartered banks subject to state supervision.

In the short run, it is unlikely that we will see again state chartered non depository institutions that are originating and selling bad mortgages. The markets have been burned and will remember for a while that such institutions may not be selling quality products. Over the years, however, memories will fade and regulatory reform enacted today should avoid problems in the future as far as possible. I urge Congress to require state regulators to partner with the federal prudential regulator in order to harmonize safety and soundness standards and to exchange information for state chartered banks and non banks. The federal prudential regulator should set out minimum standards that it would like to see in state run financial institutions. And state regulators should be

[5] See additional discussion of these issues by Douglas Elliott of Brookings and also by the current author posted on the Brookings website. The financial reform project of the Pew Charitable trusts has also posted material on the topic.

required to exchange data with the federal regulator and work in cooperation with them. This is already how things work for most banks and it is important that we do not see in the future a situation where state charters are exploited by non bank financial institutions to undercut the safety of the financial system.

The Federal Reserve as Systemic Risk Monitor or Regulator

The Treasury White Paper has proposed that there be a council, an extension of the President's Working Group on financial stability to coordinate information and assess systemic risk. The Working Group has played a valuable role in the past and I support its extension to include the leaders of all institutions with power to regulate the financial sector. As others have said, however, committee meetings do not solve crises.

The proposal outlined earlier in this testimony is for a single micro-prudential regulator, which would deprive the Fed of all its micro-prudential functions. However, I propose that monitoring and managing systemic stability and responding to increased exposure to systemic risks formally be added to the Fed's responsibilities. The strong performance of the Fed in managing this crisis strongly suggests that this institution should be the primary systemic risk monitor/regulator. Moreover, this role is a natural extension of monetary policy, which can be thought of as the monitoring of, and response to, macro-economic developments. It fits with the dominant culture of economists and the Fed's strong tradition of independence, which are both needed for systemic risk management to be effective. It would slightly cut into the role you have proposed for the Financial Services Oversight Council, but not much.

For monitoring the economy and for making monetary policy the Fed needs, among other things, quick access to a broad base of financial information. Currently, the regulatory reporting is primitive. More complete, relevant and real time data should be available to all federal financial regulators. A coordinated information strategy for the federal financial regulatory agencies ought to be one of the first tasks of the FSOC. The Fed as systemic regulator would need to work closely with the prudential regulator so that it knows what is going on inside the big institutions, and the small ones. It would also need to work closely with the Treasury and the FSOC, exchanging information with all members that could help it see dangerous trends as they emerge.

To respond to specific systemic risks, the Fed needs another instrument in addition to its control over short term interest rates and I suggest that Congress should grant the Fed the power to adjust minimum capital, leverage, collateral and margin requirements generally in response to changing systemic risks, in addition to the specific power it has had to adjust margin requirements in stock trading since the Great Depression. The micro-prudential regulator would set basic minimum standards. The Fed would adjust a "multiplier" up or down as systemic circumstances required. This additional power should be used rarely and in small increments; recall how the Volcker-Carter credit restrictions stopped the US economy on a dime in 1980.

No one can guarantee that a systemic regulator will be able to foresee the next bubble or crisis, but it is definitely worth the effort to spot trouble forming. In particular, the Fed may be able to spot a concentration of purchases of risky assets made with borrowed funds. A systemic regulator could have seen that many banks had lent large sums to LTCM to speculate in Russian bonds or other risky assets. It should have been able to spot the build up of risky CDOs in SIVs that were affiliated with the banks. It could potentially see if large hedge funds or private equity companies were using borrowed funds and concentrating on a particularly risk class of assets. Analysts who were studying the real estate market prior saw signs of trouble well before the crisis started.

Conclusions

A single strong agency would meet the objective of micro prudential regulation of all financial institutions that were subject to regulation and supervision. It would work with state regulators, especially to make sure the abuses that contributed to the crisis could not be repeated. It would work closely with the conduct of business regulator(s) (the SEC and the CFPA) and the Federal Reserve to ensure that consumer protection is adequate, that monetary policymakers are well informed and that all these institutions and the Treasury would work together effectively to deal with a new crisis should it occur in the future.

The Federal Reserve has shown its mettle in managing the crisis and should be given the role of principle systemic regulator or monitor. It would work closely with the members of the risk council in performing this task. It should have the power to adjust borrowing rules prudently if it sees a bubble developing driven by excessive leverage.

The SEC is the natural institution to become the conduct of business regulator with a mandate to protect small and minority shareholders and, with a CFPA division, also to protect consumers in financial markets. A single prudential regulator plus a single conduct of business regulator would constitute the so-called twin peaks approach to regulation that many experts around the world see as the best regulatory structure. However, a well-designed standalone CFPA could also be an effective protector of consumers and taxpayers.

Appendix: Lessons from the UK and Australia

Opponents of regulatory consolidation in the United States frequently cite the experience of the United Kingdom, which has a consolidated regulator, the Financial Services Authority (FSA) but did not escape the crisis, indeed it has suffered perhaps even worse than the United States. Given London's status as a global financial center it was to be expected that the UK would face problems in the global crisis, but it is surprising that the extensive regulatory reforms undertaken in the late 1990s did not better insulate the country from the effects of the financial crisis.

In 1997 the UK overhauled its financial regulatory system, combining a myriad of independent regulatory authorities (including the regulatory functions of the Bank of England, the Securities Investment Board, and the Securities Futures Board, among nine total) into a single entity. Then Chancellor of the Exchequer Gordon Brown argued that the distinctions between banks, securities firms and insurance companies had broken down, and that in this new era of more fluid and interchangeable institutional definitions, the old regulatory divisions no longer made sense. The FSA's statutory objectives are to maintain market confidence, to promote public awareness on financial matters, to protect consumers, and to reduce financial crime. To achieve those ends, the FSA employs broad investigatory, enforcement and prosecutorial powers.

Although the external structure of regulation in the UK may appear simple enough, there is a great deal of internal complexity. There are two main branches within the FSA; one branch which deals with retail markets and another branch, which focuses on wholesale and institutional markets. Within each branch, there are further divisions based on specific financial activities and institutional design, including insurance, banking and mortgages, asset management, and credit unions. There also exist some internal groups which look at specific financial activities in each of the retail and wholesale sectors. Therefore, in practice the FSA did not create an effective single prudential regulator. Instead it preserved some of its older agency divisions, albeit under a single umbrella. Critics of the FSA have pointed to the haste with which the FSA was formed and the failure of the new integrated regulator to fully overcome the old institutional divisions of its former approach to regulation.

The FSA has admitted on its own to significant failings over Northern Rock. An internal FSA report cited inadequate resources devoted to overseeing the institution, including high personnel turnover and limited direct contact with the institution (no one had visited the bank for three years), and a failure to push management at the bank to modify an eventually disastrous business model.[6] The UK government was determined to develop London as the key financial center in Europe and that London could compete effectively with New York. As part of this strategy, they instituted "light touch" regulation, in which financial institutions were given the goals or principles that they should follow but were given considerable leeway to determine how the goals should be met. While there is some merit in this approach, it created significant danger and it meant in practice that UK financial institutions took on excessive risks. Some UK banks developed a reputation

[6] Hughes, 2008

around the world for lending money to companies that local banks would not touch and the regulators were not stopping them from taking these bad risks.

Another problem is that there was totally inadequate communication between the FSA and the Bank of England. The Bank of England was intent on maintaining its independence and focused on its mission of fighting inflation. When the crisis struck, the Bank was unwilling to step in quickly to support troubled institutions and markets because it had not been kept up to date about the condition of the banks and had not been tasked with the job of maintaining system stability.

In summary, the UK experience does not provide an appropriate counter example for the regulatory model proposed in this testimony. They did not create an effective, strong single prudential regulator. They did not make the Bank of England responsible for systemic stability, nor did they ensure that the Bank of England was informed about the condition of the UK banks.

Australia does not have a major financial center serving the global market and so it cannot provide an ideal example for the United States to copy. Nevertheless, the Australian regulatory reforms seem to have been well designed and well-executed and there are some lessons to be learned.

Australia determined that the "twin peaks" model was the right one and they created the Australian Prudential Regulatory Authority (APRA), which is responsible for prudential regulation while the Australian Securities and Investment Commission (ASIC) oversees conduct-of-business regulation. A cross-agency commission seeks to resolve conflicts of overlap and facilitate communication between the two agencies.

The Australian economy weathered the financial crisis better than many other developed countries, and its experience owes much of its better-than-average performance during the financial crisis to sound policy choices and the effectiveness of its financial regulation. There was not a housing bubble and there was not the same erosion in lending standards as had occurred in the US. This was in part due to stricter regulation of mortgage lending. Australia's prudential regulator had raised capital requirements for banks investing in riskier mortgage products.[7] Consumer protection laws and foreclosure laws also discouraged borrowers from taking out mortgages that they could not afford.

Until 1998 Australian financial regulation resided with the country's Central Bank and took an institutional approach. Following a review of the country's overall financial system, the twin peaks approach was put into place. As in the UK, APRA's regulation is a largely a principles-based approach, relying heavily on dialogue between the regulators and the regulated institutions, but with a considerably heavier touch by the regulators to guard against excessive risk taking.

The ASIC oversees securities market and financial services providers. ASIC has the power to impose criminal or civil sanctions against financial firms or individuals. As a

[7] Ellis, 2009

corporate regulator, ASIC oversees company directors and officers, capital raising, takeovers, financial reporting, etc. It also provides licensing and monitoring for financial services firms. In addition, ASIC has been tasked to protect consumers against misleading or deceptive conduct related to financial products and services.

The Australian approach is cited as a model for other countries, for example in the Paulson Treasury's blueprint, in part because it allows flexibility and innovation, while maintaining protections. The regulatory structure is not the only reason for the fact that their economy avoided the worst of the financial crisis, but it seems to have helped. One aspect of the Australian regulatory approach that could serve as a model is the process by which it arrived at reform. Where the road to reform in the UK was hasty and lacked adequate consideration, the Australian reform process began with the Wallis Inquiry in 1996 to review how financial system reform could be structured in Australia. The inquiry looked specifically at how prior attempts at deregulation had affected the Australian financial system, what forces were at work changing the system further, and what would provide the most efficient, effective and competitive regulatory structure for the country going forward.

In summary, Australia provides a good positive example where a single prudential regulator has worked well.