

## **Comments on Professor Jackson's Presentation: An American Perspective on the UK Financial Services Authority: Politics, Goals, and Regulatory Intensity**

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It is a pleasure to comment on Professor Jackson's paper. His analysis of the FSA and its actions is extremely thought-provoking and helpful in trying to learn lessons for the United States. I have many questions as well as some comments.

### **Politics**

With respect to the politics of financial regulation in the United States, we can begin with no better an authority than the Honorable Alan Greenspan:

“The Congress serves as the ‘strategic planner’ of the U.S. financial system and in this capacity shapes the overall structure of our financial regulatory system and balances the costs and benefits of modifications to that system.” (Letter to the GAO, September 16, 2004).

Professor Jackson appears to suggest that perhaps the British Parliament may serve as a superior strategic planner in some respects.

He contrasts the creation of the FSA as a single integrated regulator in the UK in the late 1990s with the enactment of Gramm-Leach-Bliley in the US.

I would like to suggest that it is also useful to consider changes that the United States made to our regulatory structure in FIRREA and FDICIA, in the aftermath of the savings and loan debacle (and also bank failures in New England). What we did there was to add important improvements to the supervision of insured depository institutions, including the effective preemption of lax state supervision of state-chartered institutions in places such as the Southwest and Texas that had helped to create preconditions for significant taxpayer losses.

In other words, political deference to fragmented supervision and the role of state financial regulators gave way before the realization that we need to set a floor on the ability of depository institutions to precipitate serious harm in the financial system.

I would like to come back to this idea at the end of my remarks. The differences in political cultures between the US and other countries mean that reform proposals need to be shaped to make progress in the context of our peculiar system. It is clear, as Professor Jackson observes, that the Parliament can move much more quickly than the United States.

Moreover, the very structure of the FSA has echoes in American political history. The FSA is organized as a private corporation with a 16 member board of directors. Eleven members of the board are independent and five are insiders of the FSA itself.

Does this ring any bells? While the structural parallels are not complete (especially because the FSA has no shareholders), we had two Banks of the United States, private companies that were charged with regulating monetary policy and the financial system as it was in the Nineteenth Century. The destruction of the second Bank of the United States and the political triumph of smaller state banks that had chafed under the hegemony of the Bank of the United States have made a lasting mark on the history and fragmentation of U.S. financial regulation.

Indeed, just to show how entwined the financial history of the United States is with that of the United Kingdom, the FSA took over many of its supervisory responsibilities from the Bank of England which in a previous incarnation served as Hamilton's model for the first Bank of the United States.

Before we leave politics, I have a question for Professor Jackson: to what extent does the Parliament micromanage the financial system in a way comparable to the United States Congress? Consider for instance laws that the Congress enacts to protect certain financial sectors against encroachment by competitors operating under different charters.

To take but two examples from the residential mortgage market, the Congress has enacted laws protecting the insurance industry to the likely detriment of the efficiency of the U.S. financial system. Private mortgage insurance today, applied as it is to each individual mortgage, is arguably an anachronism. It potentially would be much more efficient not to insure mortgages separately, but instead to insure mortgage pools at significantly lower cost. Absent laws to the contrary, such mortgage pool insurance could come from a variety of sources or even from large lenders with the financial capacity to self-insure. However, the Congress enacted laws, in the charter acts of Fannie Mae and Freddie Mac, that require conforming mortgages with loan-to-value ratios above 80 percent to obtain individual mortgage insurance.

An analogous case could be made with respect to title insurance, which is protected from being rolled into mortgage costs by the controlled business provisions of the Real Estate Settlement Procedures Act.

Again the question: do politics in the UK extend to such protection of the franchise value of favored financial charters at the cost of innovation and more open competition?

## **Goals**

Now let's consider goals. Here, I have a question and a comment.

The question: Professor Jackson, you mention that “too-big-to-fail” remains a maligned but extant policy of U.S. bank regulators (p. 46). How does the FSA deal with “too-big-to-fail”? And, since that policy has not yet been tested in the UK, how credible is it?

Now the comment. The paper makes much of consumer protection as a major goal of US financial regulation. I believe that measures need to be analyzed before they are deemed to provide “consumer protection.” Consumer protection – especially through required disclosures such as Reg Z or the establishment of rules to allocate losses such as Reg E – can be cost effective. On the other hand, some so-called consumer protection, as in the title insurance example, can easily shade off into protection for producers rather than consumers. It is important in cross-country comparisons to determine the extent that protection of the franchise value of particular types of institutions against competition is a regulatory goal.

### **Regulatory Intensity**

The statistics on regulatory intensity are interesting. The US has many more staff occupied with financial regulation than does the FSA – 41,722 in the US vs. 2,765 for the FSA.

But this issue also might benefit from increased scrutiny. Is there any way to look at the *quality* of financial supervision between the two countries? Or do differences in legal culture swamp any effort at such qualitative judgments?

Let’s also look at another set of numbers. In the UK, some one million people work for financial services companies regulated by the FSA (Cole, p.2). In the US the comparable figure is 5.8 million employees (in 2001; GAO, p. 25). In this context it would seem to be relatively unimportant whether 42,000 staff were concerned with financial supervision or some lesser number; the personnel ratio of regulators to regulated is so small as to make those differences unimportant.

Again, the essential issue is the quality of regulation; for example, whether too many of the regulatory staffs perform unimportant or redundant or inefficient functions (such as protection of franchise value) that add little benefit to the strength and performance of the financial system.

And again this leads to a question for Professor Jackson: how does the FSA cope with information asymmetries between the regulator and the regulated firms that make examination such an important but sometimes unsuccessful function?

### **A Proposal**

The most important benefit of Professor Jackson’s paper is the way that the integrated approach of the FSA points up shortcomings in the US supervisory system. In particular, we lack a single agency that is responsible for analyzing and monitoring risks that cut across the financial system as a whole.

We do have both the Federal Reserve and the Treasury, but neither have this kind of cross-cutting responsibility.

However, in today's fluid financial sector, risks travel easily across institutions and types of institution. It was in the aftermath of the savings and loan debacle that I first perceived what I cheerfully call Stanton's Law: *risk will migrate to the place where government is least equipped to deal with it*. In the savings and loan cleanup, the Congress greatly strengthened supervision of thrift institutions and imposed bank-type capital standards and strict supervision. In the process we facilitated the shift of hundreds of billions of dollars of mortgages, and the attendant risks, to Fannie Mae and Freddie Mac, where capital standards were low and supervision was much weaker.

This country urgently needs a single organization with the capacity to monitor and analyze risk from the perspective of the financial sector as a whole, including insured depository institutions and the many major non-bank financial institutions such as GSEs, large finance companies, insurance companies and investment banking firms.

But, as Professor Jackson shows so well, the political culture of the United States will not favor a large consolidated regulator. That leads us to an idea that may meet the need for integrated risk monitoring and analysis without offending long-standing cultural norms.

The idea is simple: create an agency with the responsibility for analyzing major risks across the financial system but that lacks the authority to do anything about these risks. Wherever the agency is located, or if it is independent, it can and should be designed to have some powerful friends, to help protect its ability to report accurately on major financial risks.

There is an organizational model from the transportation sector: the National Transportation Safety Board. The NTSB is required to assess risks in the transportation sector and to examine and report on major transportation accidents. The NTSB carries out its mission in the context of powerful industry groups and firms and powerful agencies such as the Federal Aviation Administration. The FAA frequently ignores NTSB recommendations. But those recommendations are a matter of public record and are available to policymakers when the need arises.

The NTSB has somewhat different functions than the new financial analysis organization proposed here. But, similar to the NTSB, the proposed new financial organization would find strength in its weakness: without enforcement authority it is likely that information would flow much more easily from financial firms to the agency than otherwise would be the case.

This is not the same as having an FSA with the authority to analyze major risks and the power to address them. On the other hand, it falls within the piecemeal approach – seen in FIRREA and FDICIA, of making incremental reforms that help to address major concerns with respect to the financial system, albeit as in the case of those two laws, far too late.

Thank you, Professor Jackson, for sharing your most interesting piece of work with us.

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