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Financial Regulation under the Coalition Government

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1. Introduction

The Coalition government came to power in 2010 in the wake of a financial crisis that had exposed significant weaknesses in UK's financial regulatory structure. The new government's early attempts to repair these weaknesses had two elements: to the extent the financial crisis was seen as a banking crisis, it set up an Independent Commission for Banking (ICB) to identify the fault-lines. But it also launched an overhaul of the institutional architecture of financial regulation in the UK, leading to the Financial Services Act 2012. This note assesses the Coalition's record and achievements in the area of financial regulation.

While the financial crisis focused attention on the failures and near-failures of some of UK's largest retail banks, to a large extent the underlying problems had emerged from the so-called shadow banking sector. This sector comprises a variety of non-deposit-taking financial institutions which engage in maturity transformation like retail banks but lack any protection for their creditors. Without protection, this sector is particularly vulnerable to wholesale 'runs', if short-term lenders decide en masse not to roll over their debt or demand large 'haircuts' to do so. In the recent crisis, problems arose initially in markets for securities backed by subprime mortgages, but metastasised into a broader crisis of illiquidity, and eventually came to stress the balance sheets of retail banks.

Once market turmoil sets in, any fragility of financial intermediaries is vulnerable to endogenous amplification mechanisms. A bank that wants to repair its stressed balance sheet may choose to deleverage by selling some of its assets. While optimal from the standpoint of a single bank, when many financial institutions make similar adjustments simultaneously, asset prices fall; this triggers further adjustment of leverage by additional sale of assets. This "fire-sale externality" may be exacerbated by a "haircut spiral" as lenders in repo markets demand larger discounts to lend against collateral. In the recent crisis, the combination of falling asset prices and large haircuts created a downward spiral that threatened systemic stability.

The principal lessons from the crisis are clear. One, in order to manage systemic risk, we must regulate *all* institutions deemed systemic, whether they are conventional banks, investment banks or shadow banks. Two, microprudential regulation of individual institutions does not per se guarantee systemic safety, and additional tools must be employed for macroprudential regulation. Three, when a crisis sets in, some form of liquidity provision facility is essential to guard against a sudden loss of investor confidence. Finally, large, complex, systemically-important financial institutions should have relatively transparent resolution mechanisms in place. Let us consider the structure and content of regulation proposed by the Coalition government against this background.

2. The Independent Commission on Banking

As the crisis revealed many UK banks to be quite fragile, the new government established an Independent Commission on Banking in 2010 to explore structural reforms of the UK banking sector to promote its systemic stability. It sought to assess UK banks' traditional model of 'universal banking' -- that combines both retail and investment banking. It also examined the relatively concentrated structure that had emerged, with a handful of large banks dominating the industry.

The Commission's report, released in 2011, put forward a proposal to limit the interaction between the retail and investment banking functions in UK banks. It called for the assets and liabilities of the retail and investment banking functions to be separated, and the retail arm to be 'ring fenced'. The retail arm must carry capital in excess of Basel III regulatory requirements, and only capital above this enhanced level can be transferred to the investment banking part. The purpose of this restriction is to limit the risk that an investment arm that runs into trouble might drain capital from the retail operation. The Coalition government agreed to implement this proposal, but under pressure from the City, decided that the restriction would be imposed only after 2019.

In our opinion, the ring-fencing policy addresses the wrong problem. The crisis arose not within the traditional banking sector, but largely from the shadow banking sector. Unlike banks that had some depositor protection, this sector was particularly vulnerable to runs once doubts emerged about certain classes of securities. Ring-fencing, had it been in place, could hardly have prevented such runs in repo markets. More generally, systemic stability requires that all systemically important financial institutions should be subject to macroprudential capital requirements. Subjecting only banks, or only retail parts of banks, to capital restrictions simply creates distortions without much gain in systemic stability. Indeed such ring-fencing can even increase systemic risk. If the investment banking part is in trouble, a universal bank may have an incentive to shrink its retail balance sheet so that excess capital can be released to support its investment banking arm. Such asset sales can trigger fire-sale externalities.

Further, the ring-fencing proposal seems to implicitly assume that the main problem in a crisis is that of solvency. In the recent crisis many financial intermediaries who required central bank support were solvent but illiquid. A ring-fence would, once again, have made this problem worse. The liquidity from depositor funds is typically unaffected in a crisis because such funds are backed by depositor insurance (which, when designed properly, eliminates depositor runs). If the crisis is primarily one of liquidity, access to depositor funds can help investment banking activities in a crisis. Overall, in our opinion, the implementation of the ring-fencing proposal would be a step in the wrong direction.

3. A new structure for prudential regulation

In the tripartite regulatory structure created by the Labour government, the Bank of England, the Treasury and the Financial Services Authority (FSA) were collectively responsible for financial regulation. This arrangement had transferred microprudential regulation of banks, and also regulation of their conduct, to the FSA, while financial stability and lender-of-last resort functions remained a responsibility of the Bank of England. This tripartite structure was seriously tested by the crisis: with insufficient communication between the various parties as events unfolded, and poorly assigned responsibilities, this arrangement was found to have a 'regulatory underlap'.

The Coalition government remedied this by reforming the institutional structure of financial regulation, specifically to improve macroprudential oversight. A new Financial Services Act 2012, which came into force in April 2013, abolished the FSA and divided its tasks across different bodies. Conduct regulation was transferred to a new body, called the Financial Conduct Authority (FCA). A Prudential Regulation Authority (PRA) was set up under the Bank of England to return microprudential regulation to the Bank of England, while a Financial Policy Committee (FPC) was established in the Bank to maintain systemic oversight. The FPC is tasked with monitoring overall levels of leverage and credit growth in the financial system and makes policy recommendations to the PRA and FCA as well as to the Treasury. Along with the existing Monetary Policy Committee, the FPC and PRA together puts the Bank of England in charge of monetary policy, prudential bank solvency as well as systemic financial stability, making it one of the most powerful central banks in the world.

The new arrangement enables better macroprudential oversight and, as such, is a move in the right direction. However, the arrangements fall short when it comes to regulating shadow banks. In the US, the Dodd-Frank act of 2010 includes a number of measures to achieve precisely such control. The lack of any comparable attempt at gaining control over the shadow sector remains a significant weakness of the current UK regime.

4. Regulation of conduct and practice

The Financial Services Act 2012 hived off the regulation of financial services to a new Financial Conduct Authority (FCA). Consumer protection is its key remit, but the FCA is also responsible for some broader regulatory functions, notably preventing market abuse (such as insider dealing or market manipulation) and for promoting competition and innovation. Its mandate covers all firms providing retail or wholesale financial services (for instance, banks, building societies, insurance companies); its enforcement powers come from its ability to exclude individuals and firms from financial markets, to investigate financial crime and to seek criminal penalties through the legal system.

Pre-crisis conduct regulation in the UK had been celebrated as 'light touch'. Given the extent of corporate excess and malfeasance revealed in the wake of the financial crisis, some regulatory tightening was inevitable. Indeed regulatory tightening had commenced while the FSA was still in charge, and the FCA has largely continued that task using institutional assets and personnel it inherited from the FSA. In recent years, the FCA has led the investigations into the manipulation of LIBOR and foreign exchange markets by UK banks. The value of financial penalties has risen from about £34 million in 2009-10 to £425 million in 2013-14, and the FCA has also resorted to issuing public warning notices as a deterrent.

But the choice of regulatory intensity presents a familiar dilemma for the Coalition. The financial services industry continues to be a very substantial part of the UK economy and continues to lobby against 'excessive regulation' that might damage London's position as a leading global financial centre. But stronger enforcement may be critical for restoring public trust in financial institutions tainted by scandals. The on-going debate over excessive personal remuneration in the financial sector offers a case in point: despite the public hostility to a culture of large bonuses, the UK government has lobbied aggressively against EU attempts to restrain high performance-related pay in banks, and even sought legal challenges against European directives that aim to do so. Given the Coalition's reflexive preference for laissez faire policy wherever feasible, there is the risk that choice of regulatory intensity may be distorted by ideological considerations.

5. Private debt restructuring

Recent research has thrown light on the importance of private-sector debt, especially housing debt, in determining the severity of crises as well as the duration of the recessions that follow. Jorda et al. (2014), drawing on data from banks' balance sheets for 17 advanced economies since 1870, show that mortgage lending by banks has been the driving force behind the rise of the financial sector. Mortgage credit accounts for the bulk of the episodes of credit expansion and these episodes tend to be followed by deeper recessions and slower recoveries. This research programme puts housing finance at the centre of the economy, with significant responsibility for financial instability.

A related research programme by Mian and Sufi has examined disaggregated data on credit and spending from the US. Using a rich variety of sources, they establish that, after the collapse of the housing bubble destroyed the net worth of indebted individuals, the withdrawal of their private demand, more than any credit crunch, has prolonged the recent recession. If so, restructuring of housing debt must form a crucial element of any financial policy reform to enable faster recovery. The 'Help to Buy' programme in the UK, which involves provision of public equity to support investment in housing (the government puts up 20% of the purchase price thus absorbing 20% of any subsequent capital gains or losses), is a step in this direction.

6. Conclusion

Financial regulation is not easy. Regulated entities tend to devote far more resources to avoiding any regulatory burden than those available to the regulator in enforcing regulation. This reduces the information content of the measures that the regulator depends on. Further, regulation gives rise to a boundary problem: regulated entities have the incentive to try to locate economic activity just outside the purview of the regulatory authorities, as evident from the rise of shadow banking. It follows that any regulatory regime is bound to be imperfect and future crises cannot be ruled out. Casting the regulatory net as widely as possible to contain systemic risk, and planning for a soft landing should therefore form crucial parts of any regime of financial regulation.

Since 2010, the Coalition government has improved the regulatory architecture o better manage systemic risk, but the lack of any progress towards regulating shadow activities remains a significant weakness in the UK regime. The ICB proposal adds little in this regard. As for containing future crises, there remains the crucial task of designing transparent resolution mechanisms for large financial intermediaries, so that debt holders are prevented from free-riding on the public purse. A debt-restructuring regime for distressed mortgage holders would help in the event of any collapse in real estate prices. However, very little progress has been made on either front so far.

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