**Financial Stability: How are the Banks Regulated?**

**MARKET FAILURE IN THE FINANCIAL MARKETS**

When a financial market fails, it means that the price mechanism does not work effectively. A significant function of the price mechanism is allocate goods and services a price, but in financial markets, the prices of assets may not reflect the full range of costs and benefits associated with owning, or trading in, those assets. For example, failing to establish the 'risk' associated with holding a financial asset may cause a divergence between the market (or traded) value of the asset, and the true value. This can distort decision making and lead to a misallocation of resources.

One feature of the financial crisis was the emergence of 'toxic' assets, where risks were hidden, and hence market values failed to reflect the underlying value of the asset based on accurate risk calculation. There are several features of financial markets that suggest that within those markets the price mechanism may fail maximise economic welfare:

**(1) Asymmetries and information failure**

The most significant market failure affecting financial markets is the failure to provide sufficient information to make rational choices about the value of an asset. Information failure may affect the buyer or the seller, or both parties. One feature of financial markets in the period preceding the financial crash was the emergence of new types of security, and hence new types of risk. Low interest rates and poor yields from 'safe' government bonds meant that global investors were looking for new assets to invest in. This demand triggered the expansion of securitised debt, where existing debts are packaged up and sold as new assets. This encouraged the introduction of new and innovative derivatives and other instruments, such as CDOs (collateralised debt obligations). However, this meant that holders of debt became increasingly unaware of the risks they were exposed to. Consequently, they remained ignorant of the possible impact on them (or their balance sheets) of individuals and organisations defaulting on their debts.

In the absence of information, risks tended to be under-estimated, and asset values over-estimated. This meant that many institutions made less than prudent decisions about the assets that they held. This also encouraged them to lend to high risk, sub-prime, borrowers, such as those in the sub-prime housing market. Therefore many banks had assets on their balance sheet which were worth much less than the bank estimated. Once the financial crash happened, these assets became worthless and many banks faced insolvency.

**(2) Moral hazard (or is this Government Failure?)**

The failure to understand the level of risk associated with securitised assets was compounded by the assumption by many financial institutions that they were 'too big or too important' to fail, and hence would be bailed out should the need arise or had CDS (Credit Default Swaps) to insure against losses on the financial derivatives. This encouraged further risk taking above and beyond a rational level. Perhaps though there is Government Failure instead? The central bank, in its role of lender of last resort, was seen as an 'insurance policy' should the financial institutions suffer excessive losses from imprudent lending. Banks therefore continued to leverage themselves highly and leave themselves exposed to any shock. The theory of moral hazard suggests that whenever individuals or organisations are insured against suffering from the losses associated with economic decisions (either through Government protection or other financial instruments in the market), they will act with less regard to the negative impact of those decisions.

**(3) Excessive speculation**

The demand for, and supply of, financial assets is governed largely by speculative motives - buy in anticipation of a capital gain, and sell to avoid a capital loss. Given the absence of full information about future values and risks, the behaviour of speculators is subject to what Keynes referred to as 'animal spirits' and the 'herding instinct'. This means that markets can experience 'bubbles', with market values being driven up well beyond their 'true' value. Others call this the ‘fools hypothesis’. Eventually, some speculators predict that the next movement asset prices is downwards and, as a result, sell their assets to avoid a loss. This then triggers a fall in price as the 'bubble bursts', with the rest of the herd starting to sell. It can be argued that while price movements are beneficial for a healthy financial market, excessive speculation creates excessive instability, and prevents financial markets from performing effectively.

**(4) Fall-out from externalities (and systemic risk)**

Given the above failures, it is clear that, from time to time, financial markets can fail, either in a minor or temporary way - such as failing to provide sufficient liquidity - or in a way that creates significant macro-economic fall-out. The failure of one bank can have knock on effects to others especially if banks are borrowing from each other. Financial market failures can lead to numerous negative externalities, which may include: Falling real output, Rising unemployment, Falling real wages, Rising poverty levels, Falling profits and bankruptcies., Lack of competition and market rigging. The relatively small number of financial institutions dominating particular financial markets may encourage market players to collude and undertake cartel-like behaviour. Collusive behaviour may extend to market 'rigging', where asset prices, or other aspects of the market, are fixed by the dominant firms.

This is what happened in the Libor scandal (Libor is the London Interbank Offered Rate) which involved fixing interest rates and exchange rates. A Libor rate is an average interest rate (or exchange rate) calculated through submissions by major global banks. In terms of interest rates, the Libor rate is then used globally to fix rates on a variety of loans - from mortgage rates to student loan rates.

Rate submissions are supposed to be based on actual bank data, but investigations in the USA showed that five major banks – Citicorp, JPMorgan Chase, Barclays, the Royal Bank of Scotland and UBS AG - colluded over a number of years to set exchange rates in their favour. Other investigations revealed widespread rate fixing across global financial markets.

**GOVERNMENT INTERVENTION IN GENERAL**

The growth in high risk trading of extremely complex financial products, including derivatives and options, and the increasing securitisation of assets, created what has widely been dubbed a shadow banking system, which increasingly operated outside of normal banking practices.

**Banking Regulation before the crash**

Like all large businesses, banks are subject to regulation by the Competition and Markets Authority. But for specific industry regulation, up until 2013, banking regulation in the UK involved three organisations, the Financial Services Authority (FSA) the Bank of England and the Treasury. Until the banking crisis, UK banking regulation could be described as light-touch - in other words, regulators do not engage in aggressive regulation, preferring to intervene only when necessary, and only in limited ways.

The main problem for the regulators was that the heavy-touch regulation might force global banks to seek out countries where regulations were less strict. In other words, they would move out of London, leading to huge job losses in the City.

Up until 2013, the main UK bank regulator was the Financial Services Authority (FSA). It had two main objectives:

* To promote efficient and fair financial services
* To help consumers of financial services achieve a fair deal

To achieve this the FSA set standards for the activities of banks and other financial businesses, and could take action to ensure these standards were met.

**The Banking Act 2009 and the Turner Review**

In order to protect depositors and to maintain financial stability, the Banking Act of 2009 gave those organisations responsible for banking regulation the collective powers to deal with the crisis in the banking system. One of these powers is the ability to put a failing bank under temporary public ownership.

In March 2009 Lord Turner, Chairman of the FSA, published the findings of his review into the banking crisis and recommended the following:

1. A more coordinated international banking regulation, especially the creation of a pan-European regulator.
2. Banks to hold more assets and to improve regulation of liquidity through implementing liquidity ratios
3. More information to be collected from those institutions that are part of the shadow banking system, like hedge funds.
4. More regulation of overseas banks by host countries - this recommendation is largely in response to the collapse of the Iceland banks, who were unregulated by the UK regulators, but UK citizens suffered large losses.
5. Control of bank employees remuneration.
6. A review of bank's accounting practices.
7. The new (post 2013) regulatory framework

**Global Regulation**

Since the financial crisis, the UK – along with the EU and US - have introduced measures designed to separate the risk-taking aspect of financial markets from the ordinary provision of financial services, as well as strengthen banking regulation. In the EU, the European Banking Authority (EBA) will undertake periodic stress tests of national banks to assess how well they would cope in the future to financial shocks. In the UK a new regulatory structure governing financial service provision came into effect in April 2013.

Basel I & II

Basel I is the round of deliberations by central bankers from around the world, and in 1988, the Basel Committee on Banking Supervision (BCBS) in Basel, Switzerland, published a set of minimum capital requirements for banks. This is also known as the 1988 Basel Accord, and was enforced by law in the Group of Ten (G-10) countries in 1992. A new set of rules known as Basel II was later developed with the intent to supersede the Basel I accords. However they were criticized by some for allowing banks to take on additional types of risk, which was considered part of the cause of the US subprime financial crisis that started in 2008. In fact, bank regulators in the United States took the position of requiring a bank to follow the set of rules (Basel I or Basel II) giving the more conservative approach for the bank. Because of this it was anticipated that only the few very largest US Banks would operate under the Basel II rules, the others being regulated under the Basel I framework. Basel III was developed in response to the financial crisis; it does not supersede either Basel I or II, but focuses on different issues primarily related to the risk of a bank run

Basel III

Basel III (or the Third Basel Accord) is a global, voluntary regulatory framework on bank capital adequacy, stress testing and market liquidity risk. It was agreed upon by the members of the Basel Committee on Banking Supervision in 2010–11, and was scheduled to be introduced from 2013 until 2015; however, changes from 1 April 2013 extended implementation until 31 March 2018 and again extended to 31 March 2019The third installment of the Basel Accords (see Basel I, Basel II) was developed in response to the deficiencies in financial regulation revealed by the financial crisis of 2007–08. Basel III was supposed to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage.

**HOW DOES REGULATION WORK IN THE UK POST 2013?**

* **Microprudential regulation:** This regulation of UK financial services refers to the regulation and supervision of individual firms in the financial sector, to ensure that they remain solvent and operate in the interests of consumers. In effect, this means ensuring that each bank has a balance sheet which can withstand economic and financial shocks.Following the Financial Services Act (2012), the Financial Services Authority (FSA) ceased to exist, and the job of microprudential regulation was given over to a new regulatory authority - the Prudential Regulation Authority (PRA). In addition, the creation of the Financial Conduct Authority (FCA) atttempted to maintain high levels of competition in the financial sector.
* **Macroprudential regulation:** Macroprudential regulation, on the other hand, focuses on the financial system as a whole. According to the IMF, the ultimate objective of macroprudential regulation is to avoid long run losses in wealth by limiting the build-up of system-wide financial risk.

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| **MICRO PRUDENTIAL** | **MACRO PRUDENTIAL** |
| ***The Prudential Regulation Authority (PRA)*** | ***The Financial Conduct Authority (FCA)*** | ***The Financial Policy Committee (FPC)*** |
| The main objective of the PRA, which is part of the Bank of England, is to create a stable financial system. To help ensure stability, the PRA was given responsibility for the day-to-day regulation of around 1700 financial institutions, including banks, building societies and credit unions – i.e. ‘deposit-takers’, insurers and large investment firms. | The FCA, which is separate from the Bank of England, was given responsibility for ensuring that financial markets work effectively and that the conduct of firms in financial markets is acceptable, and meets the standards laid down in legislation. The FCA is, effectively, the watchdog that ensures competition is maintained, and that banks and other financial institutions do not abuse their dominant positions. The FCA is also responsible for the prudential regulation of financial services firms not supervised by the PRA, including asset managers. | In the UK, the job of macroprudential regulation under the new framework is the responsibility of the Financial Policy Committee (FPC) of the Bank of England. Its role is to identify, monitor and take action to remove or reduce ‘systemic risk’. The FPC can make recommendations and also give directions to the PRA and the FCA on actions that should be taken to remove or reduce risk. However, the FCA has no direct powers over the individual financial institutions.One of its main weapons is to undertake periodic 'stress tests' which are designed to asses how effectively the financial system as a whole deals with economic and financial shocks, such as a housing market crash or a sustained recession. |

**TOOLS OF THE REGULATOR: LIQUIDITY, CAPTIAL AND LEVERAGE RATIOs**

Liquidity means the ease and cost with which assets can be turned into cash and used immediately as a means of exchange. Certain assets are highly liquid. Notes and coins that are legal tender are perfectly liquid. Money held in sight-deposit accounts is highly liquid because it can often be withdrawn immediately without penalty (although there might be a daily limit). Other liquid assets might include treasury bills (short term government loans) and also stocks held in large listed companies (because these stocks are traded heavily each day). According to the Bank of England (July 2016) UK commercial banks hold more than £600 billion of high-quality liquid assets, which is around four times the level they held before the global financial crisis.

What are Liquidity Ratios?

A liquidity ratio is the ratio of liquid assets held by a bank on their balance sheet to their overall assets. Banks need to hold enough to cover expected demands from depositors. In the wake of the Global Financial Crisis (GFC) the Basel Agreement require commercial banks to keep enough liquid assets, such as cash and government bonds, to get through a 30-day market crisis. A high liquidity ratio may limit the amount of lending that a bank is able to do – it must maintain higher amounts of cash. This is similar to the cash reserve ratio. Banks have an incentive to lend money out in the long-term but take up short term debts to fund this.

What are Capital Ratios (sometimes called leverage ratios)?

Capital is simply another word for equity (so the money that is left once the assets have been sold off and the liabilities paid back). It is also sometimes called ‘capital reserves’. It is calculated by the capital (or equity) as a percentage of the total liabilities (or exposures). The lower the capital ratio (or percentage), the more a commercial bank is leveraging itself and the greater risks it is taking (but the more profit it is making!). In other words the bank is relying too much on debt (liabilities) to fund their activities (i.e. assets). Unlike other firms, banks appear to love borrowing and are allergic to equity, often funding more than 97% of their asset portfolio with debt. This makes it extremely challenging for banks to absorb even moderate losses. Coupled with this is the idea that the riskier and more illiquid the assets, the more potential there is for profit for the bank! Therefore banks not only have a slimmer ‘safety buffer’ by making their capital/equity a smaller proportion compared to their debts but they also take out riskier assets!

Capital ratios have become important as part of attempts to maintain financial market stability in recent years. The European Union runs regular “stress tests” to check whether banks have enough of a capital buffer to weather difficult economic/financial conditions (known as disaster scenarios). Should certain banks assets have been mis-valued and worth less that once thought (perhaps they are CDO’s back by dodgy mortgages in the US!) then a lower capital ratio means the bank is more at risk of becoming insolvent because they do not have the ‘buffer’ of equity (capital reserves) to cover the loss of these riskier assets. A Government enforced capital ratio can prevent this from happening.

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