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BEST FIT FINANCIAL REGULATORY PRACTICES: AN EU AND UK PERSPECTIVE

SESSION 3

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Best Fit Financial Regulatory Practices: *An EU and UK perspective*

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What do financial regulators do?

Authorisation

Information

Guidance

Surveillance

Enforcement

Policy

Theory and rationale of financial regulation

Market failure

- Absence of markets
- Information – apples v medical care
- Asymmetric information
- Monopolies and other market distortions
- **Externalities – systemic and *macro-prudential* risks**

International financial regulation

Regulators trapped in national jurisdictions

Domain of the regulator should be the domain of the market that is regulated

If activities relatively immobile then tendency to over-regulation in the attempt to limit systemic risk

If mobile then regulatory arbitrage results in lowest common denominator regulation, or market segmentation

Global regulatory reform agenda

Global consensus on need for more effective, better coordinated macro- and micro-prudential regulation and supervision

Legal reform necessary to ensure effective **macroprudential regulation** to monitor and control systemic risks

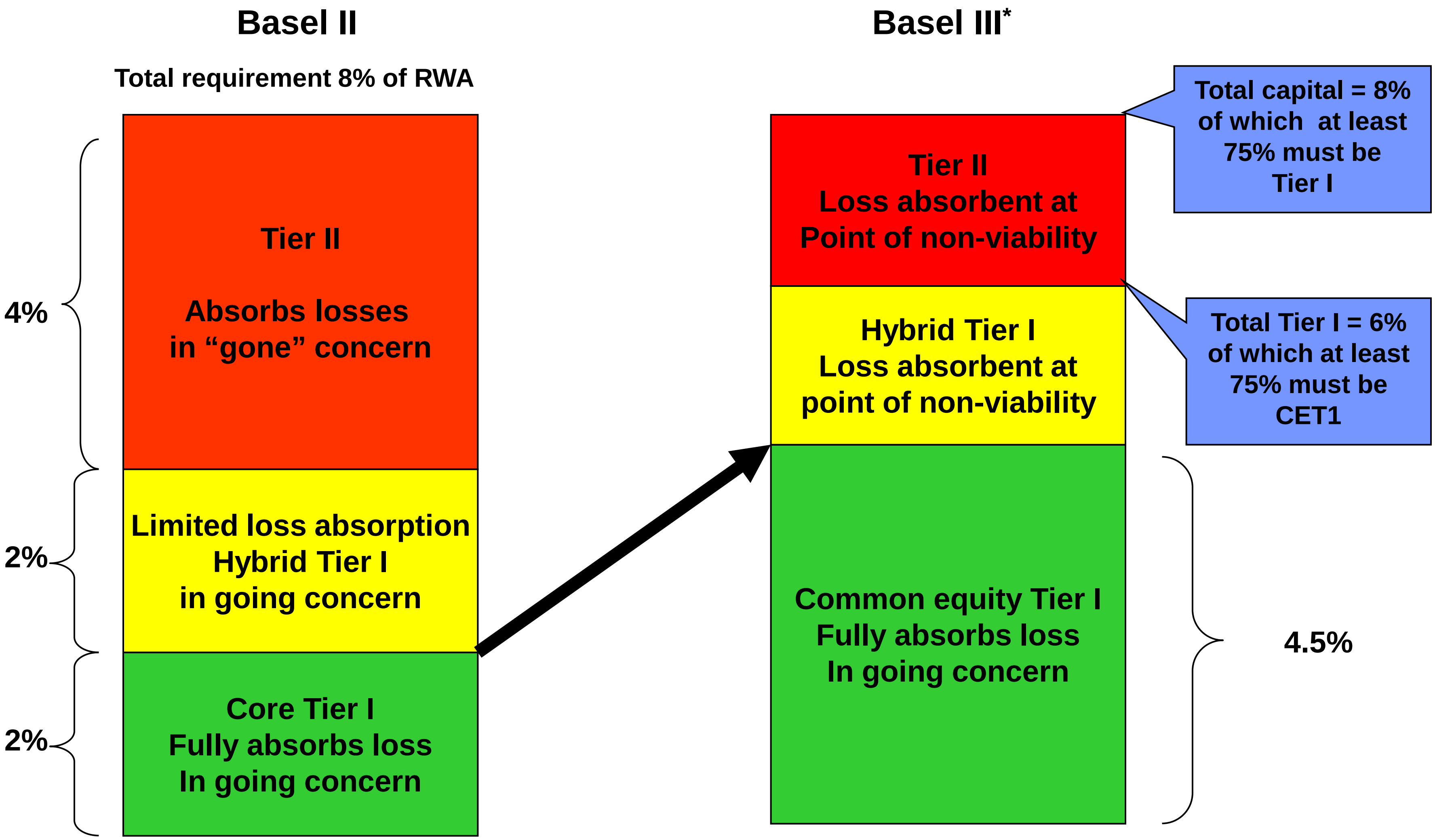
Regulatory restructuring - International, EU, National

- Global: Financial Stability Board (FSB), Basel III, IOSCO & IMF
- EU: European Systemic Risk Board & European Supervisory Authorities, Banking Union
- UK: 2 new micro-prudential regulators, a macro-prudential regulator & ring-fenced banking
- USA: Dodd-Frank Act – Financial Stability Oversight Council

International regulation

- ✓ Capital
- ✓ Liquidity
- ✓ Leverage
- ✓ Governance and risk management
- ✓ Enhancing micro-prudential regulation
- ✓ Developing macro-prudential regulatory instruments

The quality of capital will improve



* Excludes capital conservation and countercyclical buffers

Recovery and resolution plans ('living wills')

Recovery plan

Recovery Capital Plan

Recovery Liquidity Plan

Plan to sell businesses/subsidiaries

Plan to wind down/liquidate trading book

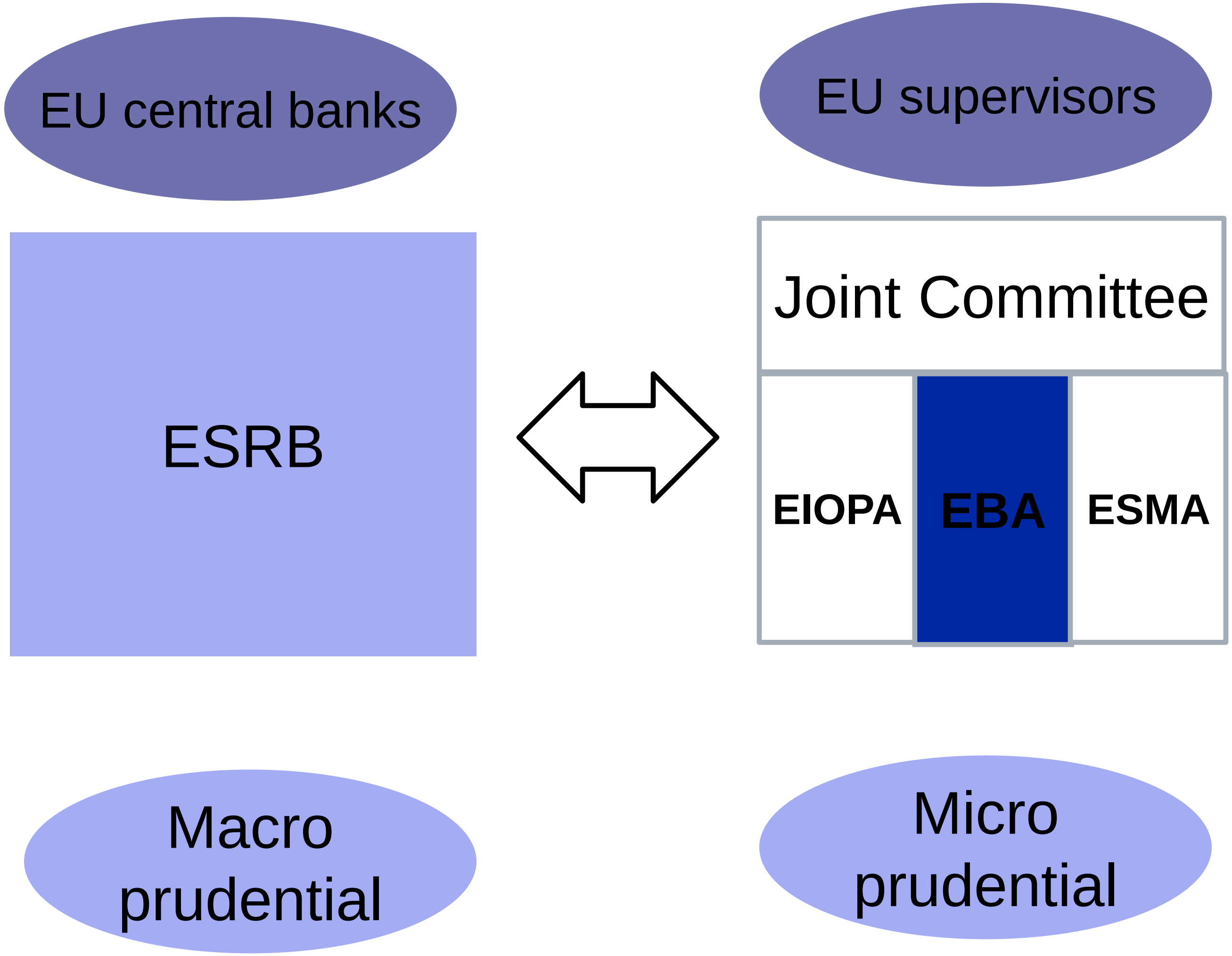
Resolution Plan

DATA →

OPTIONS

1. **Liquidation/ Deposit pay-off**
2. **Deposit transfer**
3. **Bridge bank**
4. **Bail-in**
   a. **Stay**
   b. **Conversion**
5. **Bail-out**

European Union/ Euro Area


EU central banks
EU supervisors
ESRB
Joint Committee
EIOPA
EBA
ESMA
Macro prudential
Micro prudential

New EU Structure of Financial Supervision

European Systemic Risk Board (ESRB)

- Identifies potential financial stability risks (macro-prudential oversight)
- If necessary, recommends action to EU or national authorities

Information exchange ↑ ↓ *Advice and warnings*

EBA
European Banking Authority

EIOPA
European Insurance & Oc. Pensions Authority

ESMA
European Securities & Markets Authority

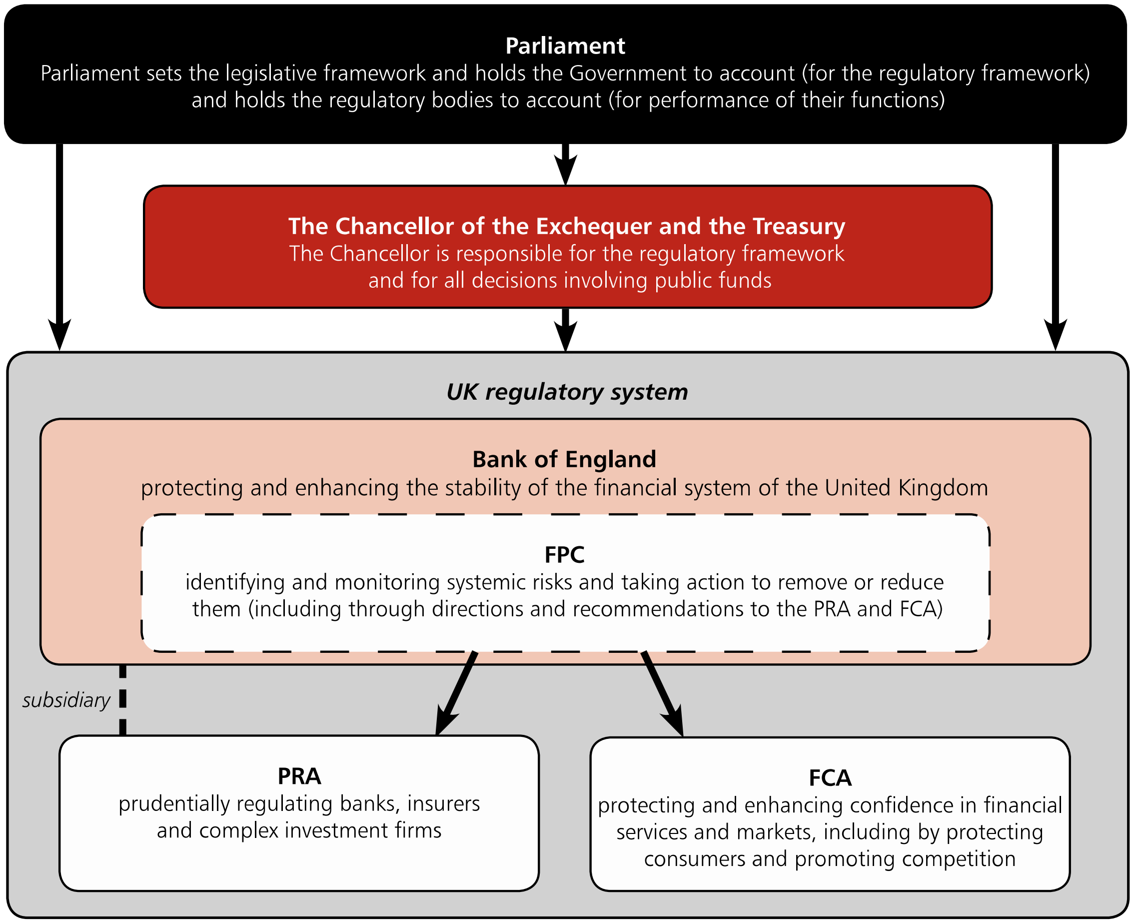
Send Board Members ↑ ↓ *Decisions in specific cases*

National Supervisors
Responsible for day-to-day supervision, cooperating in colleges

ESRB and macro-prudential regulation

- Designed to control systemic risks, which includes risks from within the financial system (interconnections and contagion between banks) and between banks and other non-regulated entities and shadow banks, and between the system and the real economy.
- 3 principles for macro-prudential policy
  - **Flexibility** in the available policy tools to prevent and mitigate specific risks, and the **discretion** to require additional disclosures and tighten temporarily a diverse range of requirements
  - **Scope to act early and effectively** before the build-up of significant imbalances or unstable interconnections
  - **Efficient ex ante coordination** between states to limit cross-border externalities and unintended effects

UK Financial Services Act 2012
Finance (Banking) Act 2013



Source: HM Treasury
Cm 8083, June 2011, p. 8

UK Institutional restructuring

Bank of England - protecting and enhancing the stability of the UK financial system, working with other bodies (BoE, PRA, FCA & Treasury), special resolution regime; clearing & settlement; payment system

Financial Policy Committee (FPC) – macro-prudential oversight. Identifying and monitoring systemic risks and taking action to remove or reduce them (including through directions and recommendations to the PRA and FCA) and devising macro-prudential tools

Prudential Regulatory Authority (PRA) (a 'subsidiary' of the Bank) - prudentially regulating banks, insurers and complex investment firms; objective of safety and soundness of individual firms

Financial Conduct Authority (FCA) - protecting and enhancing confidence in financial services and markets, including by protecting consumers and promoting competition; can use financial product banning orders; regulates exchange trading and consumer credit

- ***Judgement-led supervision (forward-looking); 'not legalistic, bureaucratic and backward-looking'***

Macroprudential Regulatory Tools

Affect balance sheets of financial institutions

Capital requirements - counter-cyclical capital buffers to dampen credit cycle. Restrictions on distributions & remuneration

Liquidity tools: Time-varying liquidity buffers, liquid assets, bank funding restrictions/limits, maximum leverage ratios

Forward-looking loss provisions: required to set aside provisions against potential future losses on their lending

Affect terms and conditions of transactions

Loan to income ratios/Loan to value ratios.

Collateral requirements (higher if lending above trend)

Securities lending limits and margining requirements

Affect market structures

Clearing houses; trading venues/capital controls; settlement, central securities depositories

Other challenges of macro-prudential regulation

Macro-prudential regulation is less amenable to the international environment

- which macro economy? Stress tests?
- home-host and the lender of last resort
- rules based
- closely linked to other aspects of national policy (macro-economic management) and international macroeconomics

Price-based v quantity-based or structural approach to regulation

- Price-based approach essentially accepts the current structure of markets, and seeks to make them "work better".
- Quantity-based approach seeks to alter both industrial structure and the domain of the market. US Volcker rule, UK bank ring-fencing

Effective regulation & supervision also depend *on*

Culture

- Shareholder stewardship (sustainable profits and mitigate social costs)
- Firms should address conflicts of interest and consumers' need for timely, accurate and intelligible information

Focus

- Pro-active oversight of whole financial system (macro-prudential)
- Forward looking assessment of potential risks (not backward looking legalistic rules)
- Rigorous challenge of bank risk models and governance

Philosophy

- Macro-prudential systemic risks and controlling externalities
- Firms should act honestly, fairly and professionally in best interest of customers
- Exercise of supervisory judgement based on discretionary powers

Legislation can influence culture, focus and philosophy

Setting clear objectives

Effectively allocates powers and responsibilities

Establishes appropriate system of accountability of regulatory bodies to the Treasury and Parliament, *yet* retains independence of judgment

Expanding the Toolkit?

- Since 2008, some financial regulators have begun looking at – and acting on – the links between *systemic* environmental risks and financial stability

- The redesign of international financial regulation – macro-prudential focus – offers opportunity to link-up different sectors of economic governance:
  - financial inclusion-financial regulation
  - foreign investment/regulation-human rights
  - environment-financial regulation

- However the fragmentation of international financial governance poses obstacles to international coordination/cooperation in banking and environmental/social regulation

- How to integrate environmental and social risks into financial regulation?
  - International Finance Corporation/Sustainability Banking Network
  - The role of the Basel Committee

State practices outside the Basel Committee in addressing environmental and social risks

China – Green Credit Guidelines

- Promoting bank lending to environmentally sustainable economic activities
- Requiring banks to include in their loan documentation covenants to comply with environmental standards
- Collect data to inform of progress and breach of environmental regulation violations

Brazil

- Using Pillar 2 to require banks to assess exposure to carbon risk
- Guidelines relating to Supervisory Review for how to consider banks' exposure to environmental and social risks
- Using Pillar 3 to require public disclosure of exposure for market discipline

Peru

- Environmental and social due diligence approach for projects
- Driving analysis and awareness

Summary

- The crisis demonstrates the need for regulators to address macro-prudential risks
- Regulatory toolkit expanding to include macro-prudential tools
- European Union and UK offer a useful approach
- Yet many gaps – and the importance for developing countries to address environmental and social risks

Further readings

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