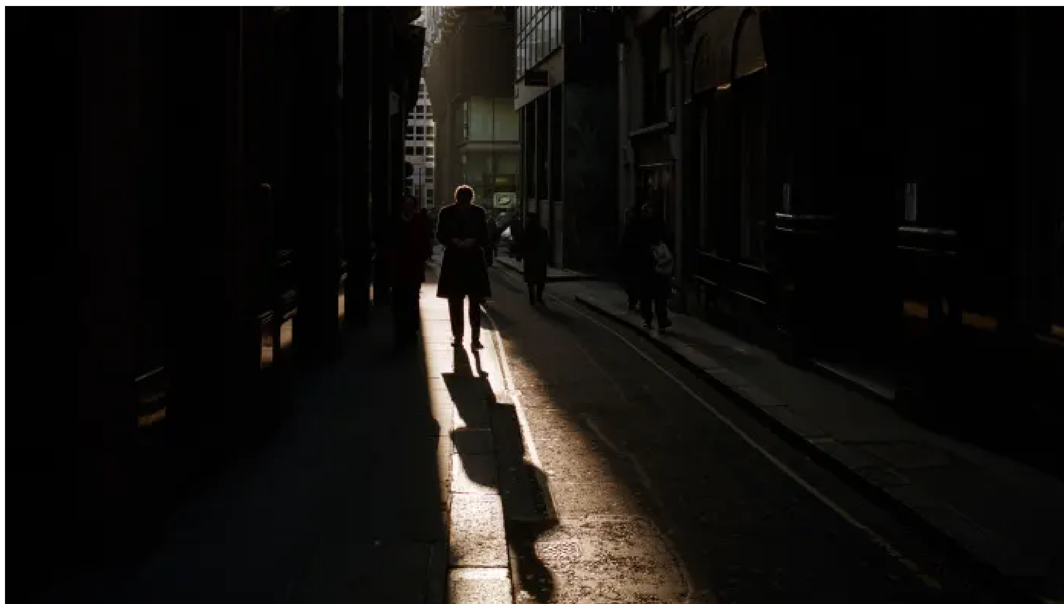
Opinion **FT Trading Room**

Bank regulators need strong principles and firm rules

As regulation tightens some of the substance of banking will surface elsewhere, says Paul Tucker



Paul Tucker JUNE 18 2014

The agencies that regulate financial markets are master craftsmen of detailed rule books. For decades, they have seen this as their main job, and for good reason. Companies prefer clear rules. Legislators want to avoid handing discretionary powers to unelected regulatory agencies. And the public rightly wants to know the standards to which companies are being held.

But there is an unfortunate flipside. Detailed rule books are the meat and drink of regulatory arbitrage. Finance is a shape-shifting industry. Complex regulations can seem to legitimise the practice of burrowing through the holes they inevitably contain. And rigid rules are of little use when activity moves outside the regulated sector.

This matters. As banking regulation becomes more stringent once again – with greater constraints on the structure of banks' balance sheets and on the types of asset they hold – some of the substance of banking will inevitably re-emerge elsewhere. This means that tightening banking regulation is not sufficient to prevent excessive liquidity risk and leverage among so-called "shadow" banks brewing another crisis

down the road. That is a strong lesson from the US experience during the 2007-09 crisis, when myriad varieties of shadow banking collapsed in a heap, spreading panic and distress through the world economy.

Policy makers understand this. Even so, they could easily find themselves in a game of catch-up, chasing one after another imaginative innovation with new rules requiring extensive consultation. This is a game they would be doomed to lose. They cannot afford to wait until it is obvious that a new incarnation of shadow banking has become systemically significant. But nor should they take pre-emptive action against every twitch of a risk. Choking off all forms of market-based finance is a recipe for financial repression and sclerosis. Judgment and flexibility will be needed.

Institutional and cultural change will be needed if regulatory agencies are to rise to this challenge.

First, the authorities need to establish which markets are especially important to the real economy, or to the financial system itself. There is risk in focusing on individual businesses, when activities spread across hundreds or even thousands of medium-sized companies can sometimes put stability in jeopardy.

To ensure the safety of the financial system as a whole, we need a clearer framework for the regulation of markets

It is important to ask whether there are ready substitutes if an important market closes; and whether the market in question would remain liquid in the event of a shock. If these questions had been asked before 2007, they would have focused attention on the markets in which asset-backed securities were traded, and in which money was borrowed against them – markets that were potent engines for leverage.

Second, securities regulators will need to broaden their priorities. In most countries, it is they who have jurisdiction over capital markets, asset managers and other manifestations of shadow banking. Historically they have focused on honesty and

efficiency rather than systemic stability. There must be no let up in measures to deter a repeat of the wave of corruption scandals over recent years. But securities regulators need to combine their vital anti-corruption agenda with a greater focus on stability. Their statutory objectives need supplementing, to give them an explicit role in preserving stability. Legislative committees and the media should ask securities regulators searching questions about risks to stability.

Third, macroprudential authorities need to be given the power to take action to forestall threats to stability – whether structural or cyclical – from anywhere in the financial system. They must be allowed some degree of discretion. Too few countries have macroprudential regimes and institutions that look fit for purpose. The International Monetary Fund should be vigilant in identifying such weaknesses in its surveillance of countries and regions.

Between them, the regulatory authorities need to pursue a range of policy measures for systemically relevant markets, covering infrastructure, the dealer community, credit rating agency practices, listing authorities and more.

Some of that is in train. But more needs to be done. For example, the listing authorities – agencies that vet every publicly issued security – should take a macroprudential approach to their functions, enabling them to make a much bigger contribution to preserving stability. Where over-issuance of a particular type of security is rendering a market fragile, they should shout. Otherwise the market will be more likely to dry up when something happens that puts it under pressure.

Most important, a framework for regulation of the money markets in the interests of stability is needed. They are the core channel through which hot money can fuel leverage and risk taking.

The re-regulation of banks has been welcome, even if it has not satisfied everyone. To ensure the safety of the financial system as a whole, we need a clearer framework for the regulation of markets, articulated as a coherent whole and based on clear economic and policy principles addressed to real-world vulnerabilities. Without that, and without giving macroprudential agencies some discretion, regulatory arbitrage will sooner or later undo the good work of the past few years.

The writer, a senior fellow at Harvard University, is a former deputy governor of the Bank of England

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