BANK OF ENGLAND

# Blueprint for resolving regulation

Article by

Paul Tucker, Deputy Governor Financial Stability, Member of the Monetary Policy Committee and Member of the Financial Policy Committee and Andreas Dombret, member of the Executive Board of the Bundesbank

Published by the Financial Times on 20 May 2012

Though central banks largely delivered price stability in the run-up to the crisis, the financial system expanded rapidly and without check. The consequences have been dreadful. There is a pressing need for countries to have what is now known as a macro-prudential policy framework to take on the task of financial stability.

Our countries are building different institutional structures. However, we have a common view of the right macro-prudential framework. First, it must be flexible and allow for early intervention. A lot of good international work is being done to strengthen the microregulatory regime. But any reforms will eventually be overtaken by the evolution of the financial system or by bursts of misplaced exuberance. Policy makers need flexibility to head off systemic risk in time to avert disaster.

Second, each jurisdiction needs to have a macro-prudential authority. And there needs to be clarity about its mandate, responsibilities, powers and accountability.

Third, those macro-prudential regulators need a “toolbox” suitable for a wide range of systemic risks. It must be able to reduce risks from interconnectedness in the system and to lean against over-exuberance, either across the whole of the financial system or in parts of it.

Fourth, we need to be clear about what tools should be available. To head off a generalised threat to solvency, an additional capital buffer may be needed temporarily to support risks in banks and, where relevant, other financial institutions. This buffer must be released as exceptional threats recede. When risks are more localised, more capital may be needed against a particular sector. Fragile funding conditions may necessitate an intervention on liquidity. And constraints on the use of margin may be needed to manage risks around secured lending. Flexibility is also essential: new threats or new insights will require new instruments.

Dangerously thin liquidity positions were one of the first vulnerabilities exposed in the crisis. We must have an international “Liquidity Coverage Ratio” to ensure liquid assets are sufficient to cover potential cash needs. We remain committed to introducing a “Net Stable Funding Ratio” so less liquid assets are funded safely.

Authorities need to have the ability to contain risks from connections in the system. Systemically important financial institutions should face tougher capital standards. And resolution regimes must be put in place to credibly deliver an orderly failure for large, cross border financial groups.

Fifth, the international regulatory regime must cater for local circumstances. In the EU, national flexibility and regional differentiation are important. Economic differences between countries of the EU are substantial, and credit cycles not always synchronised. National macro-prudential policies could be particularly useful within the euro area, where one setting for monetary policy is not always guaranteed to suit financial conditions everywhere. Not all parts of Europe experienced a lending boom before the crisis.

Sixth, an EU framework for national macro-prudential policy should be balanced with protection of the single market. That requires minimum standards. Exposures to the same risk need in normal conditions to be treated consistently.

We need to be mindful of possible unintended effects on other economies or the functioning of the single market. That calls for efficient exchange of information and co-ordination on national macro-prudential policies. The European Systemic Risk Board is well placed to play such a role in Europe; it is technically expert and, within its mandate, independent from day-to-day politics. That process should not prejudice the ability of national authorities to act early and effectively: biases towards inaction must be avoided.

The good news is the European Council, Parliament and Commission are making progress towards incorporating a framework of this kind. Jointly, we offer these six principles to guide its completion.