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Broken glass - moving towards sustainable financial regulation

Speaking in Bristol today, Michael Cohrs – a Member of the Bank's Financial Policy Committee (FPC) and a Non-Executive Director of Court, the Bank's governing body – surveys the progress of domestic and international regulators in reforming the financial system following the crisis, underlines the limitations of regulation, and highlights key challenges.

While the objective of the FPC is to look at the entire financial system, Michael Cohrs notes that – partly due to the concentrated nature of British banking – for some of its first 18 months the Committee has found itself "straying occasionally into the microprudential sphere". But he acknowledges that much of the work being done by the Bank on macroprudential regulation is unique in the global financial system and says that the Committee has learned a lot thus far. He is confident that macroprudential regulation will play an important role alongside microprudential regulation here and elsewhere.

But Michael Cohrs warns that there is "an inherent tendency for policymakers to re-fight the last war" and says "we shouldn't pretend we can eliminate financial crises completely". Underlining the importance of understanding financial history, he notes that virtually every type of financial institution has been the cause of a crisis at some point and says that, of the types of financial institutions involved in the problems of 2007/8, "I find it hard to see a common thread (other than high leverage ratios)". It is not clear, he says, that the reforms being put in place today would have, or could have, averted all the problems faced in these crises. And getting international agreement on the correct policies, getting those policies turned in to statute and implementing the new rules is not straightforward. "Perhaps the now discredited concept of allowing financial companies to blow themselves up, and then try and better deal with the fall-out, may be whether we like it or not, the reality of where we end up".

Of efforts to restructure the banking sector to create more stability, Michael Cohrs says that "if Liikanen and Vickers are enacted in full force there will be a considerable benefit ... But, unless a fear of failure changes the behaviour of bankers and investors (even in the good times), and unless new statute implements them fully – Vickers for instance called for 17% to 20% loss absorbing capital and a leverage ratio of 4.06% – I don't believe they will necessarily make financial institutions much less likely to fail although they are an important step forward". He contends that less time should be spent worrying about precisely how financial institutions are structured, or indeed the regulatory model utilised to watch over them, and more time assigned to worrying about the resources, tools and mandates given to the regulators.

Internationally, Michael Cohrs believes more thought needs to be given to creating “a better college of regulators”. He underlines the imperative of tackling the too big / too important to fail issue and says that “more urgency is needed on this key problem ... As long as financial institutions, and those who fund and own them, believe that the state will rescue them when they are in distress we will continue to have the problems that manifested themselves so brutally in 2007/2008”. He highlights a number of issues that need to be resolved in order that regulators can satisfy themselves they are heading in the right direction and states that “it is clear that under almost any set of parameters many large financial companies are both too big and complex to be managed and too big and complex to be resolved without a lot of broken glass”. Absent a clearer explanation of the benefits of size and the need to be global, the regulatory bodies should, he says, consider penalties or taxes on the largest banks to create ‘insurance funds’ which will be used when resolving one of the exceptionally large financial companies and to create an economic incentive for firms to down-size, over and above the 2.5% capital surcharge that Basel has recommended.

Michael Cohrs also reiterates his (personal) view that 2019 is too distant a date for implementing the new rules: “banks can downsize and de-lever without unduly impacting their ability to provide necessary services to their clients if they so wish”. But of the “massive” effort to create the right conditions for banks to increase the size of their loan books to stimulate economic activity, he cautions that “if we push too hard on the lending theme we will simply raise default levels, as more of the borrowers will not be creditworthy”. There is, he says, no silver bullet to quickly fix the current economic situation and it’s better to err on the side of caution. “We should worry more about ensuring that our financial institutions are well capitalized, are very liquid and have lower leverage than worrying so much about the effect that regulatory actions might have on their behaviour”.

And in changing the culture within finance to something with which society will be more comfortable, Michael Cohrs says recent events have been “a real wake up call for many”, but highlights his belief that getting the culture right is something that only management of financial institutions (and the owners) can do. “I don’t think this can be forced down from the regulators, although we can help by ensuring that incentives relating to conduct are appropriate.” As part of this, he says ‘success’ needs to be measured by a combination of factors, including “properly risk adjusted return measures that track service to the client base, as well as a report card from the regulators in terms of safety and conduct and useful innovation”.

Concluding, Michael Cohrs underlines the importance of transparency in accountability to the success of macroprudential policy. He advocates “even more dialogue between the Bank and Parliament, preferably through the Select Committee of the Treasury”. He also talks of the need for additional communication and co-operation with international regulatory authorities, as well as more frequent communication between the Bank and management of financial enterprises to better explain the thinking of the FPC. “Most of the work being done makes sense and we are moving in the right direction. But, as the memory of the crisis becomes more distant, momentum on regulatory reform might slow. We need to keep keen focus.”

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