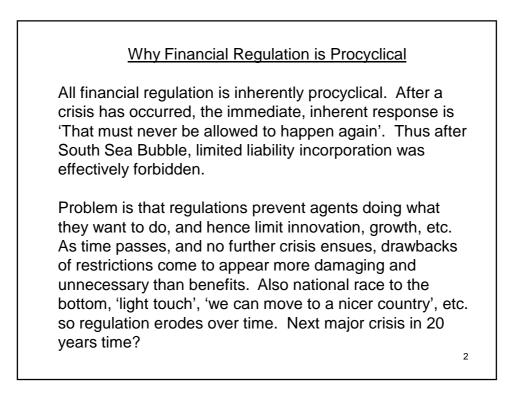


The Procyclicality of Financial Regulation: And How to Deal with it

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Also market forces make regulation procyclical. Market values, profits, capital and ease of market access to liquidity easier in boom. So a given capital/liquidity ratio can be more easily achieved in a boom. Current developments, especially in Europe, represent an extreme example. Regulatory equity requirements have gone from around 2% or less of RWA in 2007 to 9% by June 2012. Liquidity requirements are following along.

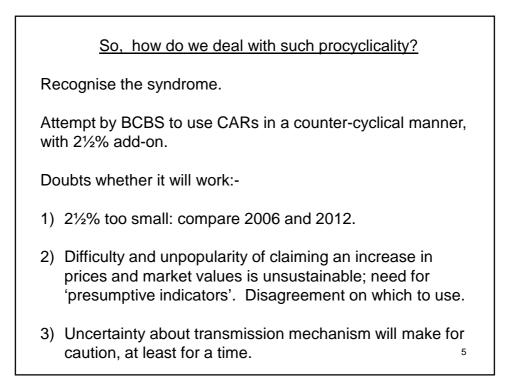
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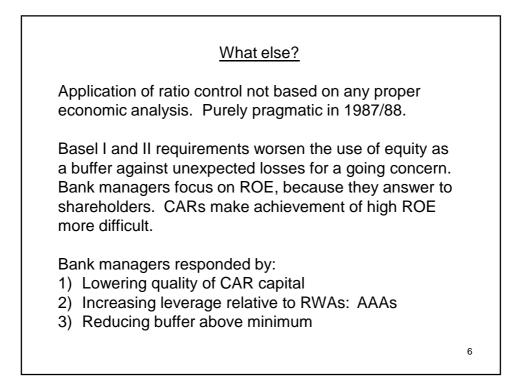
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Does it matter? If you are a monetarist, it certainly does. Tim Congdon and J. Bridges and Ryland Thomas of the Bank of England, (WP 442: 'The impact of QE on the UK economy – some supportive monetarist arithmetic').

Less so if one focusses on bank credit, because shift from deposits to capital should have very little effect, even perhaps positive, (e.g. reduce zombie loans and increase loans for new, better enterprises).

Nevertheless hardly to be recommended.





We need a new approach to ratio controls.

Instead of one ratio, two. A lower ratio where bank becomes too dangerous to allow management to continue, and a much higher, fully satisfactory level.

The two need to be connected by a ladder of sanctions, mild to begin with, more severe as we move towards closure point.

Sanctions could be charges for milder shortfalls, limits on out-payments, dividends, buy-backs and bonuses, for more serious shortfalls. Precedent in BCBS conservation range, $7 \rightarrow 4\frac{1}{2}$ %.

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