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Convergence in Europe Derailed?

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

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Why Financial Regulation is Procyclical

All financial regulation is inherently procyclical. After a crisis has occurred, the immediate, inherent response is 'That must never be allowed to happen again'. Thus after South Sea Bubble, limited liability incorporation was effectively forbidden.

Problem is that regulations prevent agents doing what they want to do, and hence limit innovation, growth, etc. As time passes, and no further crisis ensues, drawbacks of restrictions come to appear more damaging and unnecessary than benefits. Also national race to the bottom, 'light touch', 'we can move to a nicer country', etc. so regulation erodes over time. Next major crisis in 20 years time?

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.

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.

So, how do we deal with such procyclicality?

Recognise the syndrome.

Attempt by BCBS to use CARs in a counter-cyclical manner, with 2½% add-on.

Doubts whether it will work:-

1) 2½% too small: compare 2006 and 2012.

2) Difficulty and unpopularity of claiming an increase in prices and market values is unsustainable; need for 'presumptive indicators'. Disagreement on which to use.

3) Uncertainty about transmission mechanism will make for caution, at least for a time.

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What else?

Application of ratio control not based on any proper economic analysis. Purely pragmatic in 1987/88.

Basel I and II requirements worsen the use of equity as a buffer against unexpected losses for a going concern. Bank managers focus on ROE, because they answer to shareholders. CARs make achievement of high ROE more difficult.

Bank managers responded by:
1) Lowering quality of CAR capital
2) Increasing leverage relative to RWAs: AAAs
3) Reducing buffer above minimum

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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 → 4½%.

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