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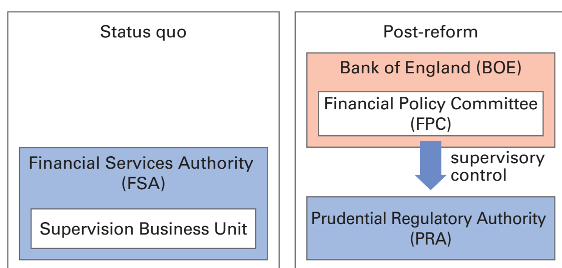
Vertical integration: UK's novel approach to financial regulatory reform

Nomura Research Institute, Ltd.

The UK has unveiled a financial regulatory reform plan that places financial regulatory authorities under the supervision of the Bank of England. Such "vertical integration" should improve coordination between the central bank, which conducts systemic risk analysis, and the regulatory authorities that take remedial action based on such analysis. On the downside, it could also give rise to new problems such as undermining financial policy independence and eliminating checks and balances among public regulatory agencies.

In a June speech, UK Chancellor of the Exchequer George Osborne announced plans to reform the UK's financial regulatory regime by abolishing the Financial Services Authority (FSA) and transferring supervision of financial institutions to a new Prudential Regulatory Authority (PRA) to be established as a subsidiary of the Bank of England (BOE) (see exhibit below). This regulatory reform's primary aim is to prevent recurrence of financial system-wide dysfunction like the recent financial crisis. In other words, it aims to prevent systemic risk. In this respect, it is similar to US and Continental European regulatory reforms in response to the financial crisis.

Exhibit. UK regulatory reform plan
(portion pertaining to financial oversight)



Segregation of duties between central banks and regulatory authorities

In terms of methodology, systemic risk prevention entails a simple three-step process. First, collect requisite data and information. Second, identify problems by analyzing the collected data and information. Third, implement remedial measures to address the problems. A general consensus about which entities are responsible for each of the steps seems to have been reached through debate about financial regulatory reform in not only the UK but also the US and Continental Europe. Specifically, the consensus is that the first two steps should be performed by central banks and the third step by regulatory authorities.

Central banks have long collected and analyzed voluminous data and information from financial markets and financial institutions to appropriately set their policy rates in pursuit of economic and price stability. They also gather market intelligence through open market operations. Utilizing central banks' data-collection infrastructure and analytical know-how is accordingly an effective and efficient means to prevent systemic risk.

The remediation step, by contrast, taps into regulatory authorities' specialized expertise. Policymaking to prevent system risk is called macroprudence. The main macroprudential policy instruments are micro measures such as restrictions on capital ratios and leverage as advocated by entities such as the Bank of International Settlements (BIS)[1]. Utilization of macro instruments such as policy interest rates remains highly controversial. It therefore makes sense to put regulatory authorities in control of micro instruments for preventing systemic risk, a role that they have long fulfilled.

Significance of "vertical integration" of financial regulatory regime

Given the need to segregate central banks and regulatory authorities' roles in preventing systemic risk, how to effectively coordinate their respective roles is an important issue.

There may be a tendency to assume that such coordination

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should be simple because both central banks and regulatory authorities are public sector entities, but this assumption is called into question by reflection on the recent financial crisis. Even during the asset bubble phase that preceded the financial crisis, many regulators, including central bankers, were aware of information and data indicative of systemic risk, such as major increases in financial institutions' leverage and buildups and transfers of risk through securitized products. Such data and information were noted in many analyses, including Financial Stability Reports[2)] issued by major countries' central banks. Ultimately, however, such analyses failed to lead to remediation.

Given the technical constraints on systemic risk analysis, this failure was undeniably partly attributable to limitations on such analysis's applicability to policymaking. However, regret that coordination between central banks and regulatory authorities, the cornerstone of systemic risk prevention, did not function well is one driving force behind financial regulatory reform in not only the UK but also the US and Continental Europe. In fact, Chancellor Osborne explicitly criticized the UK's existing tripartite system (ie, coordination among HM Treasury, the BOE, and FSA) for failing to function properly in his aforementioned speech.

What is most noteworthy about the UK's planned reform of its financial regulatory regime is that the UK has embraced an approach that can be called "vertical integration" in the sense that the PRA will be under the control of the BOE. In a speech before the House of Commons, MP Mark Hoban, who serves as Financial Secretary to the Treasury, revealed that the PRA will be under the supervisory authority of a Financial Policy Committee (FPC) to be newly established within the BOE. The UK government seems to have strong confidence that financial authorities operating under the supervision of the central bank will expeditiously take action in response to systemic risks identified by the central bank.

Downside of vertical integration of financial regulatory regime

While vertical integration is thus potentially beneficial, it also could give rise to new problems in conjunction with integration of the central bank and financial regulatory authorities.

One problem is that financial policy independence may be compromised. Regulatory authorities with jurisdiction over financial institutions must cooperate with financial authorities and the elected government itself (e.g., through resolution of failed financial institutions). Vertical integration consequently could open a channel for the finance ministry or government to influence central bank policy. In fact, Germany's central bank, the Bundesbank, opposes a vertical integration proposal similar to the UK's regulatory reform plan because banking regulatory authorities would be under the control of financial authorities.

Another potential problem is centralization of authority in the central bank. Under UK Chancellor Osborne's reform plan, the FPC would be chaired by the BOE governor, who chairs the BOE's Monetary Policy Committee also. The BOE governor would gain vast authority over financial policy and financial system stability measures. US financial regulatory reform, by contrast, will create a Financial Stability Oversight Council (FSOC) comprising representatives from not only the Fed but also the Department of Treasury and other financial regulatory agencies. The FSOC will analyze systemic risks, while each of the financial regulatory agencies will implement measures based on the FSOC's analysis. The US approach, which can be called "horizontal integration," places priority on checks and balances among public regulatory authorities.

In sum, coordination between central banks and regulatory authorities to prevent systemic risks varies among countries and is shaped largely by each country's governmental organization. It will be interesting to see how the UK specifically implements financial regulatory reform incorporating the novel concept of vertical integration of central bank and regulatory authorities, including how it addresses the potential problems cited above, by its target effective date of 2012.

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Note

1) For example, see "Macroprudential instruments and frameworks: a stocktaking of issues and experiences," BIS Committee on the Global Financial System, May 2010.

2) Financial Stability Reports are published semiannually by many central banks, including the BOJ, BOE, and ECB.

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