



BANK OF ENGLAND

Speech

The ideal post-EU regulatory framework

Speech given by

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A lot has changed since the last global financial crisis. Banks are much more resilient. The PRA has authorised 18 new banks in the past five years, with further banks in the pipeline to be authorised. The role of non-banks and market-based finance has been growing. And digitalisation is transforming a number of financial services.

In spite of these changes, the fundamental market failures that justify the need for prudential regulation remain. This is because financial firms can take actions that create “negative externalities” – jargon for someone making bets that hurt innocent bystanders when they go wrong. And in the case of “systemic” negative externalities they hurt the economy at large, as the Great Financial Crisis reminded us. Equally, these market failures need to be dealt with in a manner that does not introduce frictions that hurt innovation and long-term productivity and economic growth.

Prudential regulation that deals effectively with these market failures has to be underpinned by an appropriate institutional structure: a set of clear responsibilities enshrined in law on who sets the objective for prudential regulation and how, who regulates, and where the details of prudential regulation should sit.

But what is the ideal institutional structure that would allow us to update, change and simplify these rules?

This is a timely question. Less than a month and a half ago, the UK exited the EU. The implementation period is due to last until the end of this year. While we are in the implementation period, the Government and the regulators will continue to onshore any new financial regulations and standards coming from the EU that take effect this year. And at the end of the implementation period, the UK will be left with the same complex set of EU law and regulations onshored in a way that replicates the rather unique way the EU – as a supranational institution – the area of financial services. The technical detail of the prudential requirements will sit in a dispersed variety of places: primary legislation, a range of statutory instruments, on-shored binding technical standards, and PRA rules and guidance. This ‘patchwork’ naturally makes the framework difficult for firms to navigate – particularly smaller firms with more limited resources to devote to compliance. It is partly for that reason that the previous Chancellor Philip Hammond announced in the 2019 Spring Statement that HM Treasury will be reviewing the post-exit regulatory framework. This review will include ‘the need to ensure financial stability is delivered through an effective regulatory framework, with the responsiveness necessary for a dynamic and open financial services sector and an appropriate level of democratic accountability’.¹ The first stage of that review, focused on regulatory coordination, was launched in July 2019.² Ultimately, the design of the post-EU regulatory framework will be for Parliament to decide in due course.

¹https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/785618/WMS_final_Commons.pdf.

² For more detail on the review, see <https://www.gov.uk/government/consultations/financial-services-future-regulatory-framework-review>.

Last year Sam Woods set out a set of principles to which any future UK regulatory framework should adhere. This speech builds on these principles to propose an ideal framework from the perspective of achieving the Bank of England's objectives.³ It then looks at whether the existing empirical evidence, including some new research carried out recently by colleagues in the Bank, supports the framework.

Ideal features of the institutional structure of prudential regulation

Sam Woods' six principles of regulation are shown in Figure 1. In building the framework, I start by mapping these principles to three ideal features of regulation also depicted in the Figure.

The first feature is that the structure needs to have **dynamism**. By this, I mean adjustments made to regulation over time to incorporate updated international standards in a timely manner, including to adjust for any unintended consequences of regulation. For example if the international standards are not designed with certain business models in mind, to reflect the advance of new technologies and to reflect new risks and opportunities. I have spoken at length elsewhere about the benefits of dynamism, so will not dwell on this more here.⁴

The second feature the institutional structure should have is **time consistency**.

Time consistency is perhaps best understood by describing its opposite, time inconsistency.

Public policy suffers from time inconsistency when there is a conflict between a policymaker's short-term incentives and their long-term incentives.

In the context of prudential regulation, over the long run, a policymaker wants to avoid financial crises. Robust prudential standards are the means of achieving this.

In the short term, however, there may be benefits from weakening prudential standards. For instance, a government might benefit electorally from the resulting short-term boost to credit supply. There is empirical evidence for this happening in practice.⁵

But the long-term consequence of always acting on those short-term incentives is an unstable financial system.

The benefits of time consistency have been long recognised in monetary policy.

Finally, the structure will need to have **legitimacy**.

³ <https://www.bankofengland.co.uk/speech/2019/sam-woods-ubs-20th-annual-financial-institutions-conference-lausanne>.

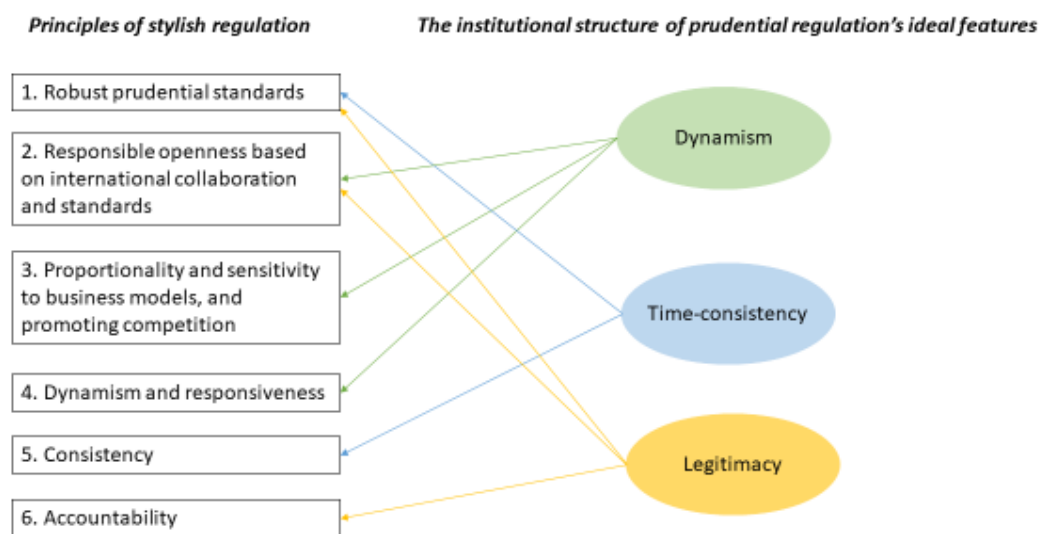
⁴ See <https://www.bankofengland.co.uk/speech/2018/victoria-saporta-speech-at-the-westminster-business-forum-keynote-seminar> and <https://www.bankofengland.co.uk/speech/2019/victoria-saporta-speech-at-risk-net-liquidity-and-funding-risk-europe>.

⁵ See Antoniadou and Calomiris (2018) and Dagher (2018).

To achieve this, the regulatory authority needs to be given a mandate.

A mandate provides a regulator with legitimacy in two ways. First, it ensures there is democratic control over the shape of the regulatory regime; e.g., the objective or objectives of the prudential regulation, the types of firm in scope, the issues the regulator must have regard to in making policy. Second, it makes possible to hold the regulator into account.

Figure 1: Links between the principles of ‘stylish’ regulation and ideal features of the institutional structure of prudential regulation



Alternative models for the institutional structure

There are broadly four alternative models for the institutional structure for prudential regulation.

The first model is that prudential regulation is specified in **primary legislation**. The approach to prudential regulation that the EU takes is an example of this model since for example regulatory requirements are mostly specified in the Capital Requirements Regulation and Capital Requirements Directive.

This means that many of the technical details that make up prudential regulation are included in legislation. This would include, for instance, the mathematical formulae used to calculate risk weights.

This model provides legitimacy because the legislation in which the prudential regulation is set out has been passed by a parliament. It is also time consistent, because a deviation from regulatory standards would require a change to legislation.

But it is unlikely to be very dynamic because the only way prudential regulation could be adjusted in response to an unintended consequence or new risk that has arisen is a change to the primary legislation, which takes time to happen.

It typically takes nine months to issue a new PRA rule – with that time including policy development, cost benefit analysis, process for public consultation, and approval by the Prudential Regulation Committee. In contrast, the process for making changes to primary legislation in the UK – which includes debates in committees and both houses of Parliament – requires finding Parliamentary time for legislation, and then after Parliamentary time has been secured, takes longer than a year to complete. Finding Parliamentary time is not an easy task, especially if the purpose of legislation is carrying out technical amendments to financial services rules. Public officials need to compete for attention with all the other important public-policy issues that Parliament and government must deal with and if they do not find a Parliamentary slot or Parliament is dissolved for elections, the legislation gets delayed for the next Queen's speech. For example, over the past six months, such events have delayed the passage of a Bill that is necessary to implement the final elements of Basel 3 (so-called Basel 3.1). By contrast, the financial regulator's task is solely focussed on delivering and maintaining rules that are fit for purpose for their regulated sector only – there is no competition for other initiatives and the process and timetable provides certainty to industry.

In a second model, prudential regulatory-setting powers could lie with **government ministers**.

This model would be dynamic because the government would be able to adjust prudential regulation. It would be legitimate since the government is directly accountable to the parliament and ultimately the electorate. But it may not be time consistent because it creates the possibility that prudential regulation will be influenced unduly by the electoral cycle, as was deemed to have happened to monetary policy prior to central bank independence.

Alternatively and in a third model, these powers could be given to an **independent regulatory body**. This model is likely to ensure that prudential regulation is both dynamic and time-consistent. An expert regulator would be able to identify and implement necessary dynamic adjustments, and, for reputation reasons, it would have an incentive to maintain prudential standards provided that it avoided industry capture. But, absent further accountability mechanisms to enhance it, it would lack legitimacy.

In summary, each of these models lacks one of the ideal features for the institutional structure of prudential regulation.

The fourth model is an **independent regulatory body with a clear mandate** set out in primary legislation and a clear set of **accountability mechanisms** to Parliament.

This model combines the benefits of an expert regulator that can adjust prudential regulation dynamically, with an objective that incentivises it to maintain prudential standards, while using the mandate and the accountability mechanisms to ensure legitimacy.

Table 1 summarises the degree to which these four models possess the three ideal features of an institutional structure of prudential regulation.

In theory at least, this fourth model is preferable because, unlike the other models, it possesses all three of the ideal features.

Table 1: Comparison of alternative models of the institutional structure of prudential regulation

<i>Model</i>	<i>Dynamic?</i>	<i>Time-consistent?</i>	<i>Legitimate?</i>
Primary legislation	X	√	√
Government	√	X	√
Regulator	√	√	x
Regulator + clear mandate +accountability mechanisms to Parliament	√	√	√

There are plenty of precedents for this institutional structure of prudential regulation, including in the UK.

The Financial Services and Markets Act 2000, better known as FSMA, established a regulator in the form of the FSA and specified the regulator’s objectives and responsibilities. The detailed regulatory rules, however, were set out by the FSA in its handbook, not written into the Act.

Following the financial crisis, the model for prudential regulation in the UK has been further developed by the establishment of the Financial Policy Committee (FPC) and the Prudential Regulation Authority (PRA). The mandates for both the FPC and PRA are set out in primary legislation: the FPC is responsible for protecting and enhancing the overall stability of the UK financial system; and the PRA’s primary objectives are to promote the safety and soundness of regulated firms and to contribute to the securing of an appropriate degree of protection for policyholders.

But importantly, the mandates for the FPC and PRA ensure that other factors such as long-term productivity and economic growth are taken into account when setting policy. The FPC must pursue its financial stability objective without causing serious harm to the wider economy in the medium or

long term. In other words, the FPC must avoid the 'stability of the graveyard'.⁶ And, the FPC also has a secondary objective, subject to its pursuit of its primary objective: that of supporting the economic policy of the government. The PRA also has an important secondary objective to facilitate effective competition, and must have regard to a set of regulatory principles, including the desirability of sustainable economic growth. Furthermore, the Chancellor writes regular letters to both the FPC and the Prudential Regulation Committee, setting out the Government's economic policy and making recommendations on how they should discharge their functions.

Importantly, the PRA takes into account the FPC's views on financial stability when setting microprudential policy. To give an example of how this works in practice – in 2015 the FPC set out the optimal overall level of UK capital requirements, balancing financial stability against economic growth. The PRC then took into account this judgement when setting individual bank capital requirements. And at the end of last year, the Financial Policy Committee (FPC) raised the structural level of the UK countercyclical capital buffer (CCyB) rate - that is the rate it expects to set in a standard risk environment - from in the region of 1% to in the region of 2%. Then, last month, the PRA consulted on proposals to reduce variable microprudential minimum requirements (so-called variable Pillar 2A capital requirements) to take account of the additional resilience associated with higher macroprudential buffers in a standard risk environment.⁷

In addition to setting out a clear mandate in primary legislation, there are also a number of accountability mechanisms in place for Parliament to scrutinise the work of the FPC and PRA against that mandate. For example, PRA senior representatives are expected to appear before the Treasury Select Committee (and other Parliamentary Committees), when requested. And the PRA Annual Report is laid before Parliament.

Outside the UK, the model of independent regulators with mandates making rules is common practice in most other jurisdictions. The need for operational independence is reflected in the Basel Core Principles for banking supervision.⁸ All jurisdictions represented in the Basel Committee implemented the Basel 3 reforms through regulators' rules or guidelines rather than primary legislation, with the exceptions of the EU, with its very specific supranational structure, and Switzerland, with its unique federal structure.

⁶ Details of the FPC's objectives and primary responsibilities are set out in section 9C of the Bank of England Act 1998. In particular, the FPC is charged with 'the identification of, monitoring of, and taking of action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system', but this does not 'require or authorise the Committee to exercise its functions in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term'. For a more detailed discussion of the FPC's mandate, see my colleague Alex Brazier's May 2019 speech, 'Citizens in service, not people in power', available at <https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/citizens-in-service-not-people-in-power-speech-by-alex-brazier.pdf>. The Governor also spoke about the trade-off as part of his speech the "Grand Unifying Theory (and practice) of Macroprudential Policy" available at <https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/the-grand-unifying-theory-and-practice-of-macroprudential-policy-speech-by-mark-carney.pdf?la=en&hash=53A55C800C6B04573DC04FD2F9579079A3503FED>

⁷ See <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2020/cp220.pdf?la=en&hash=133449CBB3D0FDD2B03AC6242C99C3F36A150258>

⁸ The second core principle states that '[t]he supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources' (https://www.bis.org/basel_framework/chapter/BCP/01.htm?inforce=20190101).

Regulatory independence and financial stability in practice

Does the evidence support the theory that an independent regulatory body with a clear mandate and strong accountability produces better outcomes?

At the Bank, Fraccaroli, Sowerbutts and Whitworth (2019) have been researching whether the institutional structure for prudential regulation affects financial stability in practice. They have done this by analysing whether there is a statistically significant association between the independence of the prudential regulator and/or supervisor and financial stability outcomes.

The authors have constructed for different countries and over time an index of regulatory-supervisory independence. The index combines three aspects of independence: institutional; regulatory; and budgetary. The definitions of these aspects can be found in Table 2.

Table 2: Definitions of aspects of independence captured in the Regulatory-Supervisory Independence index

<i>Aspect of independence</i>	<i>Definition</i>
Institutional	This captures the involvement of political bodies in the appointment and dismissal of the head of the regulatory agency, as well as length of their term. The more independent are the actors in charge of the appointment and removal process, the more independent the regulatory agency will be. Moreover, the longer the head's term, the more protected the agency is from the electoral cycle.
Regulatory	This captures whether the agency needs government approval to issue binding legislation. Higher regulatory independence allows the regulator to adapt prudential rules quickly and flexibly and to better identify with the rule-implementation and enforcement. ^(a)
Budgetary	This is based on whether needs government approval on its budget, which could affect the regulator's ability to act independently. ^(b)

(a) See Quintyn and Taylor (2002).

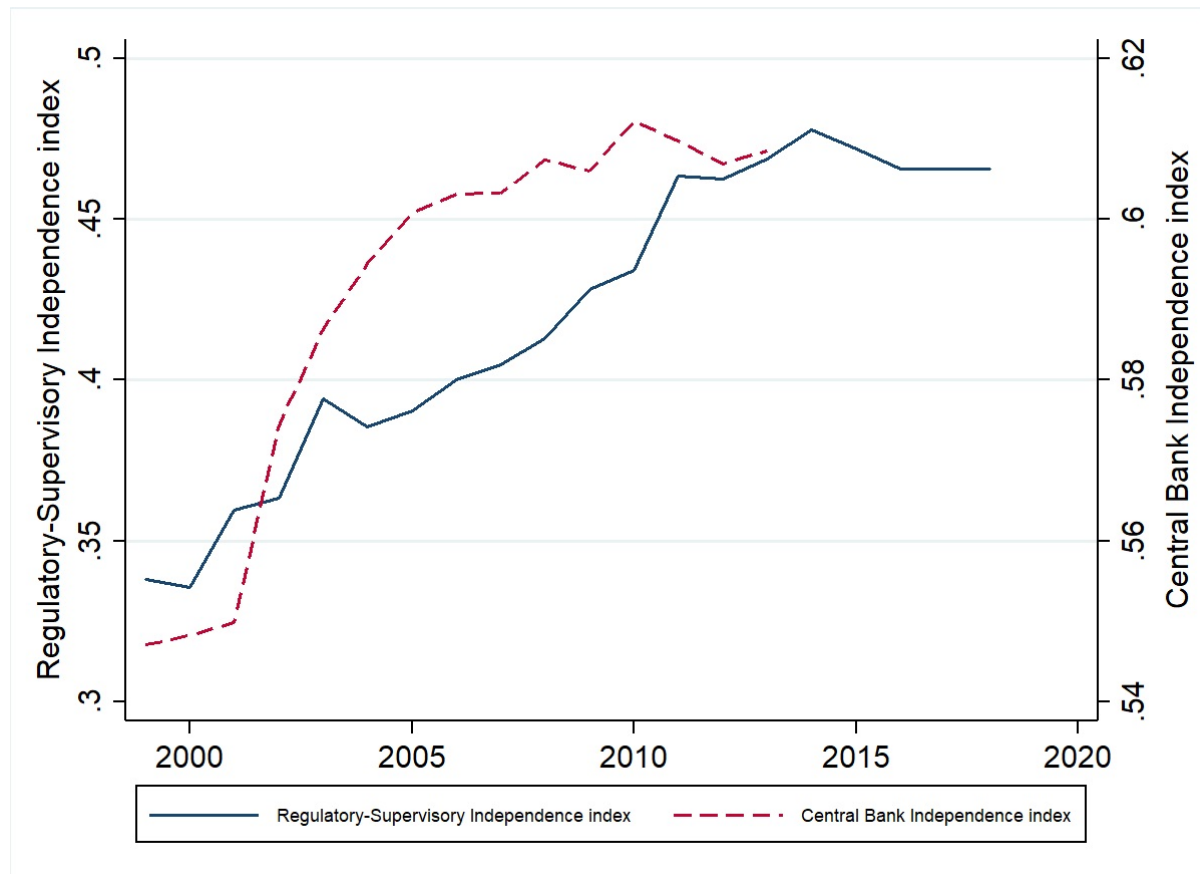
(b) See page 79 of OECD (2016).

Data on these aspects are drawn from the responses given by supervisors to a World Bank survey (Barth et al (2013)) and the statutes of the regulatory agencies and amendments to those statutes.

The authors then aggregated these aspects into a single index of **Regulatory-Supervisory Independence**, covering 43 countries and the period 1999 to 2019.

Chart 1 shows the average regulatory-supervisory index and the global average an index of central bank independence with respect to monetary policy. Both have increased over time, but central bank independence started growing earlier and initially as a faster pace.

Chart 1: Regulatory-Supervisory Independence and central bank independence, 1999-2019 (a)



(a) The data on central bank independence is drawn from Bodea and Hicks (2015) and Garriga (2016). Weighted versions of the indices are used to aid comparison. The weighting is based on Cukierman et al (1992).

The second step in the analysis was to examine whether there is an association between the Regulatory-Supervisory Independence index and financial stability.

Defining an *ex ante* quantitative indicator of the success or otherwise of prudential regulation is hard, unlike with monetary policy where such measures are easier to arrive at. But fortunately, this is less of a problem for this analysis because we have *ex post* observations of distress in the banking system. The authors used rates of non-performing loans at banks as a measure of financial (in)stability.⁹

They analyse whether reforms that increased regulatory-supervisory independence were associated with subsequent a reduction in the rates of non-performing loans. Panel data regression show a

⁹ That is, non-performing loans as a proportion of total gross loans.

negative and statistically significant association between independence-increasing reforms and rates of non-performing loans – see Table 3.

Table 3: Results for regressions of non-performing loans as % of total loans on the Regulatory-Supervisory Independence Index

	(1) ^(a)	(2) ^(a)
Regulatory-Supervisory Independence Index	-1.194 *** (0.405)	-1.300 ** (0.495)
Regulatory-Supervisory Independence Index lagged by one year		-0.970 ** (0.322)
Observations	29,782	28,002
Adjusted R ²	0.227	0.245

(a) The regression equation includes bank fixed effects, country fixed effects, and year fixed effects. Standard errors, which are clustered at the country level, are reported in parentheses. The results are robust under different specifications, including using a set of bank-specific control variables (total assets, z-score, cost-to-income ratio, efficiency ratio, total debt, total liabilities, total gross loans) and country-specific GDP growth.

This association is there even as the set of control variables in the regression is varied. The association is also persistent: the coefficient on the reforms lagged by one year is similar in magnitude and statistical significance.

The association is also economically significant. A reform that increases the index in a given year is associated with a 1.3 percentage point reduction in the rate non-performing loans and a 0.97 percentage point reduction in the subsequent year, all else equal.

These results are consistent with what other papers have found. Dincer and Eichengreen (2012) find that lower non-performing loans relative to GDP in countries in which the supervisor is independent of the government. Klomp and de Haan (2009) find a negative association between a measure of financial instability and the degree of central bank independence.

There is also evidence that supervisors that are probably more independent of the banks they supervise tend to be more robust. For instance, Agarwal et al (2014) finds in the United States federal regulators are twice as likely to downgrade banks' supervisory ratings as state regulators. Ben-David *et al* (2018) analyse the impact of supervisory responsibility for large banks moving from national regulators to the ECB's Single Supervisory Mechanism or SSM. They find banks for whom the SSM became their supervisor sought to manipulate their balance sheets to fall below the thresholds for being in scope of the SSM, suggesting banks anticipated that the SSM would be a tougher supervisor.

The results in Table 3 mean that when countries implemented reforms that increased the independence of their prudential regulator and/or supervisor, non-performing loans as a proportion of total lending decreased. Greater regulatory independence increased financial stability.

But did greater regulatory independence come at a price of less efficient banks or slower credit growth, a version of what is sometime referred to “as the stability of the graveyard”?

It seems that it did not – see Table 4.

First, the authors replaced the non-performing loans with a measure of bank efficiency: the ratio between a bank’s expenses and its income. The results show that the independence index does not have a statistically significant effect on bank efficiency contemporaneously or lagged by one year.

Second, they used the loan growth rate as a dependent variable. The result is similar: the index does not have a statistically similar effect on loan growth.

These results differ somewhat from others have found. Dincer and Eichengreen (2013) find when the supervisor is independent some measures of bank credit are lower. In contrast, Barth et al (2013b) find supervisory independence is associated with higher bank efficiency.

Table 4: Results for regressions of a bank efficiency ratio or loan growth on the Regulatory-Supervisory Independence Index

	Dependent variable	
	Bank efficiency ratio ^(a)	Loan growth rate
Regulatory-Supervisory Independence Index	1.083 (0.992)	0.027 (0.022)
Regulatory-Supervisory Independence Index lagged by one year	0.155 (0.367)	0.004 (0.015)
Observations	30,698	30,698
Adjusted R ²	0.737	0.105

(a) Defined as (non-interest expense before foreclosed property expense + amortisation of intangibles + goodwill impairments) as a percentage of (net interest income + non-interest income).

Conclusion

In this speech, I have set out a framework for thinking about ideal post-EU institutional structure. The ideal model involves independent regulators with mandates. The evidence backs that independence of prudential regulation increases financial stability with no cost to efficiency.

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