Think twice before splitting regulation

By Andrew Large Financial Times
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Recent initiatives to respond to the crisis in the financial system have been prolific. Change deserves a mixture of boldness and prudence in implementation. But how did we get into this mess in the first place?

The crisis was caused by the excessive build-up of debt and leverage, but no effective process existed to call time on the party. Politicians could boast of growth, monetary policy makers were focusing on inflation rather than debt, bankers were coining profits. Regulators lacked a focus on systemic issues and the confidence to second-guess the business strategies of individual institutions.

So the first goal is to create a systemic policy process to prevent the build-up of excessive leverage. It is a pity that in 1997, when the Bank of England was given monetary policy independence, little was done in the systemic and financial stability area.

People now see the need for a respected and independent party to monitor leverage and systemic pressures, with an obligation to intervene as necessary. Optimal assessment needs central banking and supervisory experience, supplemented by outsiders with practical skills. It needs a regular assessment cycle and the power to prescribe unwelcome measures such as raising capital adequacy ratios. It must be transparent in decision-making: not just because the medicine may be unpleasant, but as it will often be in tension with monetary policy. It would be unpopular but it would earn its legitimacy.

This thinking is now widely shared and is consistent with recent announcements from the European Union, the G20 and the Financial Stability Board. Indeed any entity would need to link in with global realities: systemic issues go beyond the UK.

In creating a process of this sort, there are parallels with monetary policy with the same issues of governance and accountability. But we need the self-confidence to create a systemic policy framework in parallel. There may be uncertainties about dealing with bubbles and asset prices, but we have no alternative to prevent a crisis happening again.

The Conservative party proposal is to create just such a framework. This is a bold approach. Politicians do not lightly cede independence to others in areas where they have the option of retaining powers. The UK would be at the forefront. Creating this process, together with other improvements in train to handle supervision better – sufficiency of powers, clarity of roles, and improved regulatory technique – would re-establish the moral high ground in financial affairs which has become so tarnished. My only difference is that the process need not be conducted by the Bank of England itself, but it should be anchored there, as is the monetary policy committee.

This leads on to the second aspect of the Conservative plans, where I have more difficulty. To my mind the architecture of which institution does what is secondary, yet the Conservatives appear to have fallen into the trap of thinking that altering the architecture will deliver a better outcome. The fact is there is no perfect supervisory architecture. Clarifying roles can be done without the need to alter who does what. However you divide the responsibilities you still need proper co-ordination. There will always be three domains: Treasury, Central Banking and Supervision. The blame should not be on the tripartite system, but on the ambiguities of roles, and imprecision – or lack – of powers that lay behind it. Conflicting priorities are inevitable. Either you handle the fault lines between institutions or you do so internally. Each approach has its merits. Internationally, success in the crisis seems unrelated to architecture.

So I am not convinced that to split the FSA and put supervision squarely into the Bank is wise or necessary, or that it will deliver a better result than the improvements under way. Changing architecture involves real risks and the burdens of migrating roles. Besides this, the consumer improvements suggested by the Conservatives do not require splitting the FSA in two. Finally, is this the right time to experiment – for the second time in 12 years – with the architecture?

There is so much else that has to be done, such as implementing the improvements to "doing supervision better". Yet the vital initiative is the creation of an effective framework for systemic policy. Let us start there.

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