

# WHAT ROLE SHOULD CENTRAL BANKS PLAY IN FINANCIAL REGULATION?

## I. Introduction

The aim of this essay is to clarify the place and the role of central banks in financial regulation. For this purpose the following question must be answered: what role should a central bank play in financial regulation? This question is not easy to answer. The role of Central Banks in the financial regulation is highly controversial and one of the most debated issues in this field. There are many questions related to it: should financial regulation have an integrated or functional character? Should central bank be banking regulator? Should central bank have power to regulate the whole financial system, also nonbanking institutions? If there is a single, integrated regulator, should it be outside or inside the central bank, so should central bank be this integrated regulator?

Historical and theoretical conditions related to this issue makes answering of these questions more complicated. There is no prescribed standard for operation of central banks and for regulation of banking and non-banking financial sectors. There is no universal model, no common scientific approach in the academia to how the financial regulation should look like. On the basis of this reality, it is difficult to argue which system is better. Moreover, after the financial crisis there are also no examples which could serve as a model for best practice. One of the main issues here is that none of the models proved to be efficient during the global financial crisis and could predict and prevent it. At the same time the crisis has sharpened the need for answering these questions and demonstrated the necessity for changes to create better system of financial regulation.

The emergence of financial conglomerates and globalized markets requires integrated regulation of the financial system. The globalization brought new reality where the financial markets have international character and operate on the world scale. Functional approach to regulation is inconsistent with this new reality. The question it follows is what role the central banks should have in this integrated regulation, whether the integrated regulation must emerge within or outside the central bank. Even though it may be argued that the central banks are better placed to effectively regulate and monitor the financial system and thus bring overall financial stability, because of the knowledge of developments in money and securities markets and in market infrastructures that central banks possess, this essay pleads

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for the integrated regulation outside the central bank. Conflict of interest problems, endangering the reputation of central bank, the danger of accumulating excessive power in hand of central bank, what can lead to negative effects and to endangering the proper conduct of monetary policy are strong enough arguments to overweight the probable positive effects of the central bank as an integrated regulator. Same can be true for the central bank as the banking regulator. Because of its financial stability function, banking system can not be wholly separated from the oversight of the central bank and the central bank will always have the certain amount of power on banking stability, necessary to meet its financial stability objective. Making central bank additionally the regulator for the banking system is therefore not important. So, the best solution is to carry on the tendency of creation the integrated regulators, established before the crisis, by creating the integrated regulators outside the central banks.

## II. The common roles of central banks in financial regulation

The safeguarding financial stability is a core function of the central bank even though it may not be responsible for regulating and supervising banks and other financial institutions<sup>1</sup>. This function of the central bank is widely recognized across the countries. All central banks contribute to financial stability through their influence on banking regulation relating to liquidity and capital<sup>2</sup>. Irrespective of the decision about the role in regulation and the supervision of individual financial institutions, the central bank has the responsibility for safety net arrangements, liquidity support, the payments system, and maintaining stability in the financial system as a whole<sup>3</sup>.

An exception of the central bank to be responsible for financial stability is the European central Bank. The

<sup>1</sup> D. Llewellyn, Institutional Structures of Financial Regulation and Supervision – The Basic Issues, World Bank 2006, p.35.

<sup>2</sup> H. Davies and D. Green, Banking on the Future : The Fall and Rise of Central Banking, 2010, Chapter 3, p.69.

<sup>3</sup> D. Llewellyn, Institutional Structures of Financial Regulation and Supervision – The Basic Issues, World Bank 2006, p.35.

responsibility for financial stability in the EU does not lie with the ESCB<sup>4</sup>. The ECB may only offer advice to and be consulted by the Council, the Commission and the competent authorities of the Member States on the scope and implementation of Union legislation relating to the prudential supervision of credit institutions and to the stability of the financial system.

### III. Central bank with or without regulatory powers – a structural dilemma

It is debated whether the aforementioned functions can be effectively performed by central banks while not also being responsible for the prudential supervision of the individual institutions that make up the system<sup>5</sup>.

International experience to this issue varies considerably. In some countries central bank is responsible only for supervising banks. In a small number of countries it has also been responsible for prudential regulation of all three sectors<sup>6</sup>. Few central banks have shown enthusiasm for taking on direct responsibilities for the supervision of nonbank financial institutions<sup>7</sup>. In many countries responsibility for prudential supervision of all financial institutions (including banks) has been withdrawn from the central bank<sup>8</sup>. National differences are based on several factors: political traditions and structure, historical evolution, the structure of the financial system, and the size of the country and financial sector<sup>9</sup>. So, there is no universal model around the globe and the question which of the different approaches is more effective is hard to answer.

#### 1. Arguments for the banking regulatory powers of central banks

There are several arguments in the literature and financial world for the banking regulatory powers of central banks. It is stated that regulatory powers eases the exchange of information, co-ordination and co-operation between the monetary and financial stability functions on the one hand and the supervision of institutions on the other<sup>10</sup>. Moreover, that it is essential for a monetary authority to have some direct links with the banking system, not only for financial stability reasons but also

to assist with the conduct of monetary policy<sup>11</sup>. Even if the banking regulation is outside the central bank, central banks are still responsible for systemic stability in the banking sector, so there might happen the duplication of roles between a central bank and a regulatory agency.

#### 2. Arguments against incorporation of banking regulation into the central banks

The arguments against incorporating the banking regulation into the central bank seem to be more powerful:

1. Conflict of interest - Central bank may misuse its powers for securing the safety and soundness of banks, what can have negative effects on its monetary policy objectives<sup>12</sup>.

2. Endangering the reputation –Regulatory failures damage the central bank's reputation and therefore its authority to conduct monetary policy<sup>13</sup>.

3. Loss of independence –regulation requires different and closer relationship with the political authorities, which may decrease the independence a central bank needs in the conduct of monetary policy<sup>14</sup>.

4. Moral hazard problem - Nonviable institutions could be inappropriately supported by the central bank to cover up the inadequacy of its own supervision, generating moral hazard and therefore potential financial instability<sup>15</sup>.

#### 3. Central Bank – integrated regulator?

The close link between financial system, financial stability and monetary policy can be seen as a justification for a central bank to be the integrated regulator of the financial system as a whole. But generally across the countries, in case of integrated regulation, this integrated regulator tends not to be the central bank.<sup>16</sup> There can be found more arguments against the central bank as an integrated regulator than for:

1. While it may be argued that central banks should regulate and supervise banks, it could be hazardous for the central bank to regulate all aspects of the financial system and all types of financial institution. One reason is the perception that the safety net might be extended to the full range of financial institutions<sup>17</sup>. A moral hazard

<sup>4</sup> H. Davies and D. Green, *Banking on the Future : The Fall and Rise of Central Banking*, 2010, Chapter 3, p.59.

<sup>5</sup> D. Llewellyn, *Institutional Structures of Financial Regulation and Supervision – The Basic Issues*, World Bank 2006, p.6.

<sup>6</sup> D. Llewellyn, *Institutional Structures of Financial Regulation and Supervision – The Basic Issues*, World Bank 2006, p.28.

<sup>7</sup> H. Davies and D. Green, *Banking on the Future : The Fall and Rise of Central Banking*, 2010, Chapter 3, p.73.

<sup>8</sup> D. Llewellyn, *Institutional Structures of Financial Regulation and Supervision – The Basic Issues*, World Bank 2006, p.28.

<sup>9</sup> D. Llewellyn, *Institutional Structures of Financial Regulation and Supervision – The Basic Issues*, World Bank 2006, p.4.

<sup>10</sup> D. Llewellyn, *Institutional Structures of Financial Regulation and Supervision – The Basic Issues*, World Bank 2006, p.32-33.

<sup>11</sup> H. Davies and D. Green, *Banking on the Future : The Fall and Rise of Central Banking*, 2010, Chapter 3, p.71.

<sup>12</sup> D. Llewellyn, *Institutional Structures of Financial Regulation and Supervision – The Basic Issues*, World Bank 2006, p.32-33.

<sup>13</sup> D. Llewellyn, *Institutional Structures of Financial Regulation and Supervision – The Basic Issues*, World Bank 2006, p.32-33.

<sup>14</sup> H. Davies and D. Green, *Banking on the Future : The Fall and Rise of Central Banking*, 2010, Chapter 3, p.76.

<sup>15</sup> H. Davies and D. Green, *Banking on the Future : The Fall and Rise of Central Banking*, 2010, Chapter 3, p.76.

<sup>16</sup> D. Llewellyn, *Institutional Structures of Financial Regulation and Supervision – The Basic Issues*, World Bank 2006, p.37-38.

<sup>17</sup> D. Llewellyn, *Institutional Structures of Financial Regulation and Supervision – The Basic Issues*, World Bank 2006, p.7.

may be created to the extent that the public may get the wrong impression that they have the same protection with all financial business as they have with banks<sup>18</sup>.

2. There is also the threat of excessive power allocation. The combination of regulatory functions with monetary control may concentrate excessive power in the hands of an unselected central bank whose accountability may be weak<sup>19</sup>.

3. The responsibility for the actions of the several financial institutions can endanger the stability of the monetary system.

This essay pleads for integrated regulation of financial markets which should be practiced outside the central banks. The arguments for the central bank as an integrated regulator are defeated by the threats this approach can provide: the problems of conflict of interest, the problem of endangering the reputation of central bank, the danger of accumulating excessive power in hand of central bank, what can lead to negative effects and to endangering the proper conduct of monetary policy. The essay takes the same approach to the banking regulatory powers of central banks. Because of its financial stability function, banking system can not be wholly separated from the oversight of the central bank and the central bank will always have the certain amount of power on banking stability, necessary to meet its financial stability objective. Making central bank additionally the regulator for the banking system is therefore not important.

#### IV. The Eurosystem perspective

Does the reality look different in the Eurosystem? Does these arguments maintain their power also in respect the Eurozone central banks? The Introduction of euro triggered several changes for the Eurosystem central banks. Eurosystem NCBs have transferred their monetary policy powers to the ESCB and now the European Central Bank has exclusive control over the monetary policy for the Eurozone member states. So, the arguments about conflicts of interests and allocation of excessive powers in hands of central banks lose their importance here. Accordingly, arguments in favour of a separation of prudential supervision and central banking lose most of their force, while those in favour of combining become even stronger. So, when viewed from a Eurosystem perspective, the attribution of extensive supervisory responsibilities to NCBs can be beneficial. The NCBs' involvement might also extend beyond the banking sector, since systemic concerns are more and more related to the presence of large, cross-sectoral organisations<sup>20</sup>.

#### V. Conclusion

There is no common approach to the appropriate role of the central banks in financial regulation. The international practice to this issue varies widely, which makes the judgment of efficiency of one or another system almost impossible.

There is no universal regulatory model in financial regulation. According to the historical experience and the practice, none of the in the world existing models can be declared as a standard or a good example of best practice. The global financial crisis demonstrated that all structures were equally ineffective. Nevertheless, the integrated regulation must be deemed as the right perspective of development of the financial regulation. Integrated regulation is in line with the recent tendencies of the financial system, but important is to create this integrated regulation at all levels, national, regional and international. The globalization has created new reality where the functional approach to regulation becomes inconsistent with the global character of the markets and with the emerged financial conglomerates. So, the integrated financial regulation is the requirement of the present state of the financial system and the markets. The essay argues that this integrated regulation has to be outside central banks.

The question arises here is that: Is it really the regulatory structure that matters rather than the way the decision within this structure are made? As Llewellyn in his article argues, It is an illusion to believe that there is a superior model of institutional structure that is applicable to all countries. Equally, it is an illusion to believe that any structure can guarantee effective and efficient regulation and supervision of the financial system. Changing the institutional structure of regulation should never be viewed as a panacea, or as a substitute for effective and efficient conduct of regulation<sup>21</sup>.

<sup>18</sup> D. Llewellyn, Institutional Structures of Financial Regulation and Supervision – The Basic Issues, World Bank 2006, p.32-33.

<sup>19</sup> D. Llewellyn, Institutional Structures of Financial Regulation and Supervision – The Basic Issues, World Bank 2006, p.32-33.

<sup>20</sup> European Central Bank, The Role of Central Banks in Prudential Supervision.

<sup>21</sup> D. Llewellyn, Institutional Structures of Financial Regulation and Supervision – The Basic Issues, World Bank 2006, p.7.

### რა როლი უნდა შეასრულონ ცენტრალურმა ბანკებმა ფინანსურ რეგულირებაში?

სალომე ჯიბუტი  
ლონდონის ეკონომიკისა და სოციალურ  
მეცნიერებათა სკოლის მაგისტრანტი

ცენტრალური ბანკების როლი ფინანსურ რეგულირებაში უპირველეს ყოვლისა განისაზღვრება მათი ადგილით მოცემული ქვეყნის ფინანსური რეგულირების სისტემაში. ავტორი ასკვნის, რომ დღეისათვის მსოფლიოში არ არსებობს რაიმე ერთი უნივერსალური ფინანსური რეგულირების მოდელი და რომელიმე საუკეთესო პრაქტიკა, რომელიც სხვაზე უკეთესია. მსოფლიო ფინანსურმა კრიზისმა აჩვენა, რომ ყველა მათგანი ერთნაირად არაეფექტიანია. გამომდინარე ამ მდგომარეობიდან, ავტორის აზრით, განვითარება უნდა წარიმართოს ინტეგრირებული და არა ფუნქციონალური ფინანსური რეგულირების მიმართულებით, ბანკების რეგულირება უნდა იქნას ინტეგრირებული ერთიან ფინანსურ რეგულირებაში და ინსტიტუციურად ის უნდა განხორციელდეს ცენტრალური ბანკების გარეთ.