A research agenda for financial regulation:
As easy as ABC?

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Financial regulation aims to enhance stability, assure market integrity and protect consumers. The crisis arguably demonstrated that financial regulation failed on all three counts: instead of stability there was the Great Recession; instead of market integrity there was market rigging and insider trading; instead of protecting consumers regulation and supervision failed to stop numerous abuses including without limitation predatory lending and mis-selling. Consequently, the G-20 leaders commissioned officials to develop and implement an agenda for reform that would fix these shortcomings. This is now largely in place.

What significance should this have for the research agenda? "Momentous," would be my response. First, there should be studies regarding the effects of particular regulations pertaining to capital, liquidity, banking structure, resolution, etc.

Second, and far more importantly, researchers might explore the ABCs of finance:

- the ***A***uthorities,
- the ***B***anks and
- the ***C***ustomers (***C***onsumers and ***C***ompanies) as well as
- ***C***ounterparties and ***C***apital markets.

Traditionally, banks have been and still are at the heart of the financial system. They perform critical economic functions such as making payments, settling securities transactions and acting as custodian for portfolios owned and/or managed by others. Banks are also prominent lenders, particularly to small-and-medium-sized enterprises (SMEs) that underpin employment and economic prosperity in Europe. These functions place banks at the centre of the transmission mechanism from monetary policy to the real economy and world at large.

During the Great Recession that transmission mechanism sputtered and stalled, causing the real economy to do so as well – something central banks' macro models never envisioned (as they did not contain a financial sector at all). To contain the crisis and reboot the real economy, policymakers provided massive support to the financial sector, especially banks as well as massive stimulus to the economy via

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monetary and fiscal policy. This included novel techniques such as quantitative easing. To repair the transmission mechanism policymakers instituted a series of reforms to reduce the probability that firms, especially banks, could fail and to reduce the impact that firms could have on financial markets and the economy at large, if they did fail.

These policy measures have dominated the research agenda in financial regulation and deservedly so. They have deepened our understanding of key issues including without limitation capital, liquidity, risk governance, market structure and disclosure as well as recovery and resolution. Such research is important and should continue. It is, if you will permit me to revert to my ABCs, about making banks better.

But research should also in my opinion look at the Cs, specifically counterparties and capital markets. Let me mention two areas in particular: central counterparties and the role of capital markets.

With respect to central counterparties, policymakers essentially accepted the view that such entities reduced systemic risk. Policymakers therefore enacted legislation requiring banks to clear standardised instruments, especially derivatives, through central counterparties.

Is this a good thing and can it be made to work? Research to date has demonstrated that central counterparties do not eliminate risk; they mutualise it. Hence, central counterparties are potentially a single point of failure. If they are not robust, is mandatory clearing pushing the system to use what could become "Fukushimas for finance"?

With respect to capital markets, policymakers appear to take two views:

- Capital markets are inherently unstable, and banks should stay away from them. This view has led to restrictions on banks engaging in trading activities as well as an increase in capital requirements for the trading activities which banks will be permitted to continue to conduct.

- Capital markets are an alternative source of financing. Subject to appropriate controls, capital markets can reduce the reliance of the financial system upon banks. This view has led to increased scrutiny of non-bank finance (a.k.a. shadow banking) as well as increased controls over securities funding and securitisation. But it is also behind capital markets union in the EU.

Can such a shift to capital markets work, and what would be the implications for the transmission mechanism if it did? Do markets need market makers, and, if so, is the stand-alone investment bank a viable business model? If banks cannot make markets or can only make markets at much higher cost, will markets deliver the liquidity and immediacy of execution that issuers and investors seek?

Suppose such a shift to capital markets succeeds, as it has arguably done in the United States. What does that imply for banks and their role in the transmission mechanism? If banks are excluded from capital markets, will their portfolios become less liquid and lower rated? If so, will they in fact be safer and sounder? And, if banks play a lesser role in financial markets overall, will they continue to be critical to the transmission mechanism? Will banks remain "special"?

Finally, let me turn to the A in my ABCs, namely the authorities – central banks, resolution authorities, finance ministries, supervisors and regulators. Here, my focus is on authorities as actors, rather than authorities as regulators or supervisors.

In my opinion there are a number of issues here on which research might usefully focus:

1. Constructive ambiguity or constructive certainty: what is correct in the case of resolution? What is correct for emergency liquidity assistance (ELA), taking into account that ending ELA can be tantamount to pulling the trigger for resolution whilst extending ELA can facilitate forbearance? What combination of policies is correct? Is current policy the wrong way round (see Table 1)?

Table 1
Constructive ambiguity and constructive certainty: is current policy the wrong way round?

	ELA	Resolution	Comment
1.	Certainty	Ambiguity	Certainty to grant ELA creates forbearance, increases loss given resolution (LGR). Ambiguity with respect to resolution plan increases variance of LGR and raises risk level.
2.	Certainty	Certainty	
3.	Ambiguity	Ambiguity	
4.	Ambiguity	Certainty	Ambiguity regarding ELA limits forbearance, reduces LGR. Certainty with respect to resolution (announcing and sticking to a 'presumptive path) increases certainty that investors will suffer loss and may reduce variance in LGR.

2. Market discipline: to what extent will the market free ride on supervisory discipline? If resolution reform puts investors at risk, will investors take into account the quality of supervision that banks receive and the ability/willingness of supervisors to place banks into resolution as soon as the

bank reaches the point of non-viability? If investors do take supervision into account, will this prompt banks to "race to the top"?

3. Direct government/central bank involvement in financial markets. This can have significant effects on markets and financial stability. Issues to consider include:

    a. Government-owned and sponsored enterprises (GSEs) are frequently assumed to operate to a higher standard and therefore to require less active supervision. Is/should that be the case?

    b. Government/central bank role as purchaser of assets – should it function as a purchaser of last (or even first) resort? How does this affect the pricing and market liquidity of the instruments eligible for purchase? Do regulatory and supervisory decisions (e.g. zero risk weights for government bonds/reduced risk weights for agency bonds and exemption from concentration limits) weaken risk management at banks and exaggerate these effects? Does government involvement shift the balance between banking and capital markets, reduce the need for banks to retain long-term assets (e.g. mortgages) on their balance sheet and therefore make it easier for banks to meet net stable funding ratios?

    c. Governments/central banks as issuers of currency. Recently Andy Haldane suggested that notes and coins should be abolished and currency should be issued in electronic or digital form (let's call them GovBits) by the central bank. This would enhance the flexibility and effectiveness of monetary policy, for it would remove the zero lower bound on interest rates.

    Is this the only effect such a step might have? Before rushing to introduce digi-cash research might explore:

    - Impact on banks. GovBits could require every user to have what amounts to an account at the central bank. This could be quite attractive relative to bank deposits, particularly if GovBits were to accrue interest (positive as well as negative). Taken to the extreme, the transfer of GovBits from holder A to holder B could come to displace much, if not all, of the traditional payment system(s).

    - Impact on credit provision. If the introduction of GovBits were to induce a shift from deposits to digi-cash, what assets would the central bank acquire in response? Would the central bank

step into the void that might be created, if banks had to step back from SME lending?

In other words, would the introduction of digi-cash by the central bank effectively amount to the nationalisation (without compensation) of banking functions? If so, will this be the end of banking as we know it?

In summary, as these brief remarks attempt to show, there is no shortage of questions to which research might usefully provide an answer. Both policymakers and practitioners await the results.