AQA Economics A-level

Macroeconomics

Topic 4: Financial Markets and Monetary Policy

4.4 The regulation of the financial system

Notes

Regulation of the financial system in the UK

- Governments might regulate banks with regulation and guidelines. This helps to ensure the behaviour of banks is clear to institutions and individuals who conduct business with the bank.

- Some economists argue that the banks have a huge influence in the economy; if they failed it would have huge consequences. Therefore, it is important to regulate the banking industry.

- The UK banking industry is regulated by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The FCA regulates financial firms to ensure they are being honest to consumers and they seek to protect consumer interests. The FCA also aims to promote competition which is in the interests of consumers. The PRA promotes the safety and stability of banks, building societies, investment firms and credit unions, and ensures policyholders are protected.

- The Financial Policy Committee (FPC) regulates risk in banking and ensures the financial system is stable. It clamps down on unregulated parts and loose credit. The committee monitors overall risks to the financial system as well as regulating individual groups.

Why a bank might fail

- The Global Financial Crisis is sometimes called The Great Recession, and it refers to the decline in world GDP in 2008-2009.

- Before the crash, asset prices were high and rising, and there was a boom in economic demand. There were risky bank loans and mortgages, especially in the US where government securities were backed by subprime mortgages. This means the borrowers had poor credit histories, and after house prices crashed in the US in 2006, several homeowners defaulted on their mortgages in 2007. Banks had lost huge funds, and required assistance from the government in the form of bailouts.

- There are risks involved with lending long term and borrowing short term. They might lose money on investments, and if there are insufficient funds in a vault, banks might not be able to provide depositors with money when it is demanded.

Moral hazards

A moral hazard is a situation where there is a risk that the borrower does things that the lender would not deem desirable, because it makes the borrower less likely to repay a loan. It usually occurs when there is some form of insurance for the mistake. For example, if a house is insured, a borrower might be less careful because they know any damage caused will be paid for by someone else.

Banks might take more risks if they know the Bank of England or the government can help them if things go wrong. The financial crisis has been regarded as a moral hazard, due to the degree of risk taking.

Systematic risks

Systematic risk in financial markets can be seen as a negative externality. Systematic risks are the risk of damage of the economy or the financial market. For example, it could be the risk of the collapse of a bank. Since this costs firms, consumers, the economy and the market, it is akin to a negative externality.

Liquidity ratios and capital ratios and how they affect the stability of a financial institution

A liquidity ratio is used to determine how able a company is to pay off short-term obligations. The higher the ratio, the greater the safety margin of the bank. When creditors want payment, they look at liquidity ratios to decide whether the bank is a concern.

A capital ratio is a comparison between the equity capital and risk-weighted assets of a bank. A bank's financial strength is determined using this. Assets have different weightings, where physical cash has zero risk and credit carries more risk.

The recent financial crisis showed how having insufficient finance, in either capital or liquidity, can be dangerous. Another risk that comes with this is that investors might assume other banks will fail as well, which reduces confidence.