OCR Economics A-level

Macroeconomics

Topic 5: The Financial Sector

5.3 Financial Regulation

Notes

Role in regulation of the banking industry

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.

The role and functions of a central bank

The central bank manages the currency, money supply and interest rates in an economy. For example, the European Central Bank (ECB), the Bank of England and the People's Bank of China are central banks.

Implementation of monetary policy

The central bank takes action to influence the manipulation of interest rates, the supply of money and credit, and the exchange rate.

In the UK, the Monetary Policy Committee (MPC) alters interest rates to control the supply of money. They are independent from the government, and the nine members meet each month to discuss what the rate of interest should be. Interest rates are used to help meet the government target of price stability, since it alters the cost of borrowing and reward for saving.

The bank controls the **base rate,** which ultimately controls the interest rates across the economy.

Banker to the government

The central bank provides services to the Central Government. It collects payments to the governments and makes payments on behalf of the government. It maintains and operates deposit accounts of the government. The central bank also manages public debt and issues loans.

The Bank can also advise the government on finance, including the timing and terms of new loans.

Banker to the banks – lender of last resort

The Bank of England is considered to be a lender of last resort. If there is no other method to increase the supply of liquidity when it is low, the Bank of England will lend money to increase the supply.

If an institution is risky or is close to collapsing, the Bank might lend to them. This is when they have no other way to borrow money.

It can protect individuals who deposit funds in a bank and might otherwise lose them. It also aims to prevent a 'run on the bank', which is when consumers withdraw their bank deposits in a panic, because they believe the bank will fail.

Usually, banks will avoid borrowing from the lender of last resort, because it is suggests the bank is experiencing a financial disaster.

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Evaluate the role of the IMF and the World Bank in regulating the global financial system

The World Bank and IMF are sometimes called the Bretton Woods Institutions. They aim to provide structure and stability to the world's economic and financial systems.

Almost every country is a member of both institutions. The governments of each member nations own and direct the institutions.

The World Bank mainly focuses on development. The IMF tries to keep payments and receipts between countries logical and ordered.

World Bank

The World Bank can loan funds to member countries, and its aim is to promote economic and social progress by raising productivity and reducing poverty.

The World Bank is involved in several projects globally, such as providing microcredit, supporting education, and helping the rebuilding of countries after earthquakes.

International Monetary Fund (IMF)

The IMF aims to promote monetary cooperation between nations, and monetary problems can be consulted in the institution.

It also aims to help free trade globally, so jobs are supported. The IMF promotes exchange rate stability and tries to avoid competitive depreciations in the currency.

Members can also borrow from the IMF, such as if they need to correct an imbalance in the balance of payments.

External debt is the amount of money owed to foreign lenders. Governments, firms and consumers could be borrowing money. Money is owed to commercial banks, governments and international institutions, such as the IMF and World Bank.