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## **THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION**

### **Policy-makers must now transform macro-prudential regulation principles into practical tools for doing the job**

"Policy-makers have embraced the general principles of macro-prudential regulation, but have so far not succeeded in transforming these into practical mechanisms for doing the job," claim the authors of the latest *Geneva Report on the World Economy*.

'The Fundamental Principles of Financial Regulation' which circulated widely earlier this year in draft form and has had a strong impact on policy discussions, will be published on Thursday 2nd July 2009 by the International Centre for Monetary and Banking Studies and the Centre for Economic Policy Research.

In the past, financial regulatory systems assumed that regulations that make individual banks safe also make the financial system safe. The eleventh Geneva Report on the World Economy showed that this thinking is flawed. Actions that banks take to make themselves safer can - in times of crisis - undermine the system's stability.

The Geneva Report advocated a different approach: micro-prudential (i.e. bank-level) regulation, plus macro-prudential (i.e. system-wide) regulation, and careful coordination of the two. Macro-prudential regulation in particular needs to offset the natural decline in measured risk during booms and its rise in subsequent collapses. "Counter-cyclical capital charges" are the way forward; regulators should adjust capital adequacy requirements over the cycle by two multiples - the first related to above-average growth of credit expansion and leverage, the second related to the mismatch in the maturity of assets and liabilities. Macro- and micro-prudential regulation should be carried out by separate institutions since they differ in focus and expertise required: central banks should be tasked with macro-prudential regulation, financial services authorities with micro-prudential regulation. Improved international coordination is also important.

Policy-makers initially embraced the idea with enthusiasm. Yet despite much talk of the need for macro-prudential regulation and its cousin, systemic risk regulation, it is hard to find any detailed macro-prudential regulation in the US administration's recent white paper on financial regulation. Bank of England Governor Mervyn King has also pointed out that despite being given broader responsibility for systemic risk by the UK Government, he has not yet been given any macro-prudential tools to achieve it. The European Commission and the euro area's authorities have yet to convince member governments that macro does not mean national, despite the existence of a monetary union.

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