Consequences of clearing

Observers question centralised regulation approach

by John Nugée in London

Tue 28 Feb 2017

In his OMFIF City Lecture on 22 February, Sir Jon Cunliffe, deputy governor of the Bank of England, presented a robust assessment of the state of the world's 'financial infrastructure' – the clearing and settlement systems that underpin financial markets.

Central counterparties were presented as the solution for a financial system whose linkages are too complex and interwoven. The result of this complexity has been that no one has full oversight of the risks in the system. Centralised regulation and robust risk buffers were, Cunliffe claimed, making the system resistant to almost all conceivable risks and defaults by participants.

While accepting that financial infrastructure is a utility that lends itself to monopolistic providers, in the discussion that followed the lecture Cunliffe's audience focused on three consequences of the direction that global regulators have chosen.

First, there is the considerable centralisation of risk. There are actually two centralisations implied in the chosen structure of central counterparties: the concentration of risk in the counterparty itself, and the concentration of the regulatory response. Any given function of the market infrastructure, such as the clearing and settlement of foreign exchange transactions, has just one central clearing agent and one set of regulations. As long as the central counterparty stays operative, this is both effective and efficient. However, several in the OMFIF audience could not help recalling the warning 'don't put all your eggs in one basket'. Cunliffe's response – in effect, 'yes, but it is an extremely strong basket' – raises the issue of how regulators can be sure of this strength when faced with future crises.

Second, the globalisation and synchronisation of the rules has given regulations a considerably greater role in business planning. Financial innovation is increasingly shaped not only by the optimal business model, but by the demands of regulators. An example of this is the proposed link between the London Stock Exchange and Deutsche Börse. The final shape of the merged company would owe more to the need to satisfy regulators than to customer requirements. It is not necessarily sufficient to say that the model which best meets regulatory requirements will, owing to its superior robustness, be the best for the customers.

Third, with every tightening of the regulatory environment there is a further diminution in the moral dimension of financial sector activity. There are so many regulations on financial actors these days, and the veto power of compliance officers so great, that a new tercet has become the mantra for innovators: 'If something is not specifically forbidden then it is allowed; If something is allowed then someone will do it; If someone else will do it then I must do it first.' But nowhere in this chain of reasoning is the financial sector encouraged to ask itself, 'just because I can, does it mean I should?'

Cunliffe, like all regulators before him, chose not to answer this. The shifting ground of the morals of finance is one the wise regulator takes care to avoid. But 10 years after the financial industry comprehensively lost its reputation for probity, the moral question still resonates.

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