

Topic: Central bank and bank regulation

Learning objectives

- Explain the functions and rationale of a central bank;
- Understand how monetary policy is transmitted through the banking system;
- Examine the rationale, types, and legal frameworks for bank regulation;
- Assess the impact and limitations of regulation on bank behavior and competition

Central Banking

A central bank can generally be defined as a financial institution responsible for overseeing a country's monetary and financial system. Unlike commercial banks, which primarily provide banking services to households and businesses for profit, a central bank performs functions in the broader public interest.

The core functions of central banks in any countries are to manage monetary policy with the aim of achieving price stability (inflation\); to prevent liquidity crises, situations of money market disorders and financial crises; and to ensure the smooth functioning of the payments system.

Explain Monetary Policy Vs Fiscal Policy

Explain Financial system.

It is important to note that, in addition to monetary policy objectives, the majority of central banks operate under the presumption that they have a policy responsibility for financial stability.

In Uganda, the **Bank of Uganda (BoU)** is the central bank. It was established in 1966 and is responsible for monetary policy, currency issuance, financial-sector supervision, foreign-exchange reserves, payment systems and other central-banking functions.

Key take away; the bankers are always eager to hear the monetary policy stance of the central bank because of its direct and indirect effects on their operations

What are the main functions of a central bank?

Functions are commonly grouped into macroeconomic and microeconomic/financial-stability roles. Key functions include:

Monetary policy and currency management

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- Formulate and implement monetary policy to achieve price stability (and sometimes full employment or growth objectives).
- Control the money supply and influence interest rates via instruments such as open-market operations, policy rates (discount/repo rates), reserve requirements, and (in recent decades) unconventional tools (quantitative easing, forward guidance, targeted longer-term refinancing).
- Issue and manage the currency (notes and coins) and oversee the integrity of the monetary system.
- Manage official foreign-exchange reserves and, where relevant, intervene in FX markets or administer exchange-rate policy.

Banker to the government (fiscal agent)

- Hold government deposits, manage the Treasury's cash, underwrite or manage public debt issuance, and provide advice on monetary and financial matters.

Banker to commercial banks and lender of last resort

- Hold (and sometimes require) commercial-bank reserves.
- Provide short-term liquidity through standing facilities, discount windows, or open-market operations.
- Act as lender of last resort in systemic stress to prevent fire sales and contagion.

Financial stability, supervision, and payments

- Supervise or contribute to the supervision of banks and (increasingly) other financial institutions; set or enforce capital, liquidity, and prudential standards.
- Oversee or operate key payment and settlement systems to ensure safety and efficiency.
- Promote overall financial-system stability (macroprudential policy in many modern frameworks).

Role of the central bank and monetary policy transmission through banks. (Student assignment)

Bank Regulation (Look at financial stability function)

Banks occupy a special position in an economy because they perform several functions simultaneously. They accept deposits from the public, provide credit, facilitate payments, create money through deposit creation, and channel savings into productive

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investment. Because banks deal extensively with other financial institutions and economic agents, the failure of one major bank can have effects beyond the individual institution.

Bank regulation therefore refers to the rules, laws, standards and requirements imposed by government and regulatory authorities on banks and other financial institutions to promote safety, soundness, efficiency, fairness and stability in the financial system.

In Uganda, the principal banking regulator is the Bank of Uganda (BoU). BoU states that its regulatory and supervisory framework covers licensing, capital and liquidity requirements, governance, risk management, market conduct and financial stability.

A useful distinction should be made between:

- **Bank regulation;** establishment and enforcement of rules governing banks.
- **Bank supervision;** monitoring banks to determine whether they comply with the rules and remain financially sound.
- **Bank resolution;** measures used to deal with a bank that has become distressed or failed.
- **Prudential regulation;** regulation aimed primarily at the safety and soundness of individual institutions and the financial system.

2. Rationale for Bank Regulation

There are several reasons why banks cannot simply be left to operate entirely according to market forces.

Protection of depositors and consumers

The most fundamental reason for regulating banks is to protect depositors. banks are among the leading repositories of the public's savings, especially the savings of individuals and families. While most of the public's savings are placed in relatively short-term, highly liquid deposits, banks also hold large amounts of long-term savings in retirement accounts. The loss of these funds due to bank failure or crime would be catastrophic to many individuals and families. However, many savers lack the financial expertise or depth of information needed to correctly evaluate the riskiness of a bank or other financial-service provider.

Therefore, regulatory agencies are charged with the responsibility of gathering and evaluating the information needed to assess the true condition of banks and other financial firms to protect the public against loss. Periodic examinations and audits are aimed at limiting losses from embezzlement, fraud, or mismanagement. Government

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agencies stand ready to loan funds to financial firms faced with unexpected shortfalls of spendable reserves so the public's savings are protected.

To ensure systemic stability;

Systemic stability is one of the main reasons for regulation, as the social costs of bank failure are greater than the private costs. Financial stability has become a common term since the 2007–2009 financial crisis. At the core, financial stability implies that the financial system – which includes financial intermediaries, markets and market infrastructures – is capable of withstanding shocks, whatever the origin of such shocks, without major disruption to the real economy. Because banks are interconnected (interbank lending, payments systems, correspondent banking), the failure of one bank can trigger contagion and threaten the entire financial system, a cost borne by third parties not party to the original transaction. This is the core justification for macroprudential regulation.

to ensure the safety and soundness of individual financial institutions;

This concern is at the core of micro prudential regulation, which relies on the view that if banks do not take excessive risks, the financial system will be safe and the real economy will not suffer from a financial crisis. Banks can increase profitability by taking greater risks. For example, a bank could: lend to highly risky borrowers; invest heavily in volatile assets; borrow excessively; concentrate lending in one sector; rely excessively on short-term funding. While these activities may generate high returns when successful, they can produce severe losses when conditions deteriorate. Prudential regulation therefore places limits on excessive risk-taking.

Maintaining public confidence and preventing bank runs

Banks engage in **maturity transformation** (borrowing short via deposits, lending long) which makes them inherently vulnerable to runs. A loss of confidence in one bank can be self-fulfilling and can spread (contagion) even to solvent banks. Regulation (deposit insurance, lender-of-last-resort access, liquidity rules) is designed to keep public confidence intact.

For example:

Deposits: withdrawable immediately or within a short period

Loans: repayable over 3–10 years

This creates a maturity mismatch. If depositors believe that a bank is in trouble, they may rush to withdraw their funds. This is known as a **bank run**.

Efficient Allocation of Credit and Payment System Integrity

Banks and their closest competitors provide individuals and businesses with loans that support consumption and investment spending and are central to the payments systems in most economies. Therefore, disruption imposes broad economic costs (credit crunches, disrupted commerce), justifying regulatory oversight of solvency and operational resilience.

Consumer protection

Another goal of banking regulation is to protect consumer interests in various aspects of a banking relationship.

The previous regulatory objectives serve to protect consumers in a number of ways, most notably through safeguarding their deposits and promoting competitive banking services. However, there are many other ways consumers are protected in their banking activities. The first is to require financial institutions to provide their customers with a meaningful disclosure of deposit and credit terms. The main intent behind such disclosures is to give customers a basis for comparing and making informed choices among different institutions and financial instruments. The disclosure acts also serve to protect borrowers from abusive practices and make them more aware of the costs and commitments in financial contracts. A second purpose of consumer protection legislation is to ensure equal treatment and equal access to credit among all financial customers.

Types of regulation

Systemic (macro-prudential) regulation

Macro-prudential regulation aims to mitigate risk to the financial system as a whole and uses primarily prudential tools to limit systemic risk and to mitigate its effects on the real economy. Simply put, it focuses on the **stability of the financial system as a whole**, rather than any single institution.

Key concerns include:

- Preventing systemic risk — the risk that the failure of one institution or market triggers a cascade across the wider system
- Monitoring interconnectedness between banks, insurers, and other financial firms to limit the build-up of systemic financial risks.
- Tools: countercyclical capital buffers, stress testing of the system as a whole, limits on leverage across the sector

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Macro-prudential policies focus on the interaction between the financial institutions, markets, infrastructure and the wider economy. In addition, macroprudential policies aim to ensure that large, systemically important financial institutions (SIFIs) are subject to more stringent prudential requirements and supervision than smaller players. This is because the potential failure of such institutions would have more serious consequences to the financial system and the economy as a whole.

Macro-prudential supervision is concerned with the aggregate effect of individual banks' actions. Because it aims to generate an overall picture of the functioning of the financial sector, macro-prudential supervision is also referred to as 'top-down supervision'.

Macro-prudential regulation, also covers all public policy regulation designed to minimise the risk of bank runs that goes under the name of the **financial safety net**. In particular, the safety net encompasses two main features – deposit insurance arrangements and the lender of last resort (LOLR) function:

- Deposit insurance is a guarantee that all or part of the amount deposited by savers in a bank will be paid in the event that a bank fails.
- The LOLR function is one of the main functions of a central bank. The central bank, or other central institution, will provide funds to banks that are in financial difficulty and are not able to access any other credit channel. Through the LOLR mechanism, the authorities can provide liquidity to the banking sector at times of crises.

prudential (or micro-prudential) regulation

Micro-prudential regulation focuses on the **safety and soundness** of individual financial institutions.

Micro-prudential supervision checks that individual financial institutions are complying with financial regulation and involves the collection and analysis of information about the risks that the firms take, their systems and their personnel. Because micro-prudential supervision uses firm-specific information to generate a picture of risk and its management, it is also referred to as 'bottom-up supervision'.

Key concerns include:

- Ensuring firms hold adequate capital and liquidity to absorb losses
- Assessing individual firm risk management, governance, and solvency
- Preventing individual firm failure (and thereby protecting depositors/policyholders)

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- Tools: capital adequacy requirements (e.g., Basel III), liquidity coverage ratios, individual firm supervision and stress testing

Conduct of business regulation – this focuses on how banks and other financial institutions conduct their business. This kind of regulation relates to information disclosure, fair business practices, competence, honesty and integrity of financial institutions and their employees. Overall, it focuses on establishing rules and guidelines to reduce the likelihood that:

- consumers receive bad advice (possible agency problem);
- supplying institutions become insolvent before contracts mature;
- contracts turn out to be different from what the customer was anticipating;
- fraud and misrepresentation take place;
- employees of financial intermediaries and financial advisors act incompetently;
- insider trading takes place;
- money will be laundered

Comparison of Uganda, UK and US

Uganda

Uganda doesn't use a clean "twin peaks" split; it's a sectoral/institutional model with multiple regulators divided by industry rather than by function:

- **Systemic regulation:** Sits mainly with the **Bank of Uganda (BoU)**, which as central bank has overall responsibility for financial stability, alongside the **Financial Sector Stability Forum (FSSF)**; a coordination platform bringing together the CEOs of Bank of Uganda, the Capital Markets Authority (CMA), the Deposit Protection Fund (DPF), the Insurance Regulatory Authority (IRA), the Financial Intelligence Authority (FIA), the Uganda Retirement Benefits Regulatory Authority (URBRA), and the Microfinance Regulation Department (MRD). This forum exists precisely *because* systemic oversight is fragmented across so many separate bodies, it's a coordination mechanism rather than a single systemic regulator.
- **Prudential + conduct regulation is bundled together, by sector**, not separated as in the UK. Each regulator does both jobs for its slice of the industry:
 - **BOU**; banks and deposit-taking microfinance institutions (prudential *and* conduct)

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- **Capital Markets Authority (CMA)**; stockbrokers and dealers, investment advisors, collective investment schemes, fund managers
- **Insurance Regulatory Authority (IRA)**; insurance companies
- **Uganda Retirement Benefits Regulatory Authority (URBRA)**; pension funds
- **Microfinance Regulation Department (MRD)**, under the Ministry of Finance; Tier 4 (non-deposit-taking) microfinance institutions, SACCOs, moneylenders
- **Financial Intelligence Authority (FIA)** AML/CTF, cutting across all sectors

This "many regulators, one per industry" structure has drawn criticism: Uganda currently has six financial services regulatory authorities, and commentators have argued that consolidated regulation would better mirror an industry structure where banking, insurance, securities, and pensions are increasingly integrated. So Uganda illustrates a genuinely different model from either the UK or US; regulation organized by *industry sector*, with prudential and conduct concerns handled by the same body within each sector, and systemic oversight achieved through inter-agency coordination rather than a dedicated systemic regulator. New Vision

United Kingdom; "Twin Peaks"

The UK is the textbook example of separating regulation by *function* rather than industry:

- **Systemic: Financial Policy Committee (FPC)**, housed within the Bank of England; sets macroprudential tools (countercyclical buffers, sectoral capital requirements) across the whole system.
- **Prudential: Prudential Regulation Authority (PRA)**, also part of the Bank of England; supervises the safety and soundness of banks, insurers, and major investment firms.
- **Conduct: Financial Conduct Authority (FCA)**; a separate body regulating how *all* firms (not just PRA-regulated ones) treat customers and behave in markets, plus market integrity.

The same firm (e.g., a large bank) is typically regulated by *both* the PRA and the FCA simultaneously; one function, two regulators, split cleanly by purpose.

United States; Fragmented, by Institution Type *and* Function

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The US is the most fragmented of the three, with overlapping bodies at both federal and state level:

- **Systemic: Financial Stability Oversight Council (FSOC)**, chaired by the Treasury Secretary, coordinates across agencies and can designate non-bank institutions as systemically important. The Federal Reserve also plays a systemic role through stress testing (CCAR) of large banks.
- **Prudential:** Split by charter type; the **Federal Reserve** (bank holding companies, state member banks), **OCC** (nationally chartered banks), **FDIC** (state non-member banks, deposit insurance), plus state banking regulators; separately, **state insurance commissioners** regulate insurer solvency (insurance is *not* federally regulated in the US).
- **Conduct:** Also split **SEC** (securities markets and broker-dealer conduct), **CFTC** (derivatives/futures), **CFPB** (consumer financial protection across banking products), and **FINRA** (self-regulatory body for broker-dealers), plus state insurance regulators again for insurance conduct.

So the US combines Uganda's sectoral fragmentation *and* the UK's functional split, multiplied by a federal/state divide, arguably the most complex of the three.

Limitations of regulation

Moral Hazard from Safety Nets

Financial regulation and supervision are needed because moral hazard can be associated with government safety net arrangements that are designed to protect the banking and financial system. For example, banks that face liquidity problems and cannot borrow from other banks in the market may approach the regulators to act as a lender of last resort in order to provide emergency liquidity assistance. This, in principle, seems a good thing as the authorities have a mechanism for providing liquidity to the banking system at times of crises. However, moral hazard arises in that if banks all believe they have access to the LOLR, they may be inclined to take on excessive risks knowing that in the event of trouble they will be bailed out by the authorities (in other words, the taxpayer, as these are public funds being used).

Banks may also benefit from regulatory forbearance.

Regulatory forbearance (or renegotiation) is an example of time inconsistency. Time inconsistency refers to the problem that it may not be optimal ex post (after an event occurs) to implement regulations that were optimal ex ante (before the event occurred). When financial intermediaries are in trouble, there may be pressures not to apply existing regulations, for example, to impose higher capital or liquidity requirements. This is

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because it could worsen the institution's problems. If the bank was allowed to fail, this could drain the deposit insurance fund. Furthermore, publicity surrounding a bank facing difficulties may worry the public, who may be induced to withdraw their savings, thereby aggravating the bank's problems (with a possible domino effect on other institutions leading to further bank failures). Also, there might be political costs associated with enforcing regulations and therefore an incentive to delay action.

Regulation can create problems of agency capture – that is, the regulatory process can be 'captured' by producers (in this case by banks and other financial institutions) and used in their own interest rather than in the interests of consumers. For example, some have argued that the Basel II Capital Accord had too much input from banking sector participants and large banks in particular. The Basel II capital rules allowed the largest banks to use their own internal models for assessing risk and capital adequacy positions, which are likely to have led the biggest banks to hold less capital for regulatory purposes. The fact that major banks have had a strong say in devising regulations that govern their own operations is a possible indicator of agency capture.

Unintended effects on credit supply and market structure due to compliance costs

Compliance costs are the costs to firms and individuals of those activities required by regulators that would not have been undertaken in the absence of regulation. Regulation is a costly business and the costs of compliance with the regulatory process will be passed on to consumers, resulting in higher costs of financial services and possibly less intermediation business. In addition, regulatory costs may act as a barrier to entry in the market and this may consolidate monopoly positions.