MN10403:
Lecture 12.

Financial Market Regulation

Lecture Structure

- Reasons for and against regulation
- Reasons for and against self-regulation
- Developments in regulation in the 1980s and 1990s
- Effects of globalisation and derivative markets
- International attempts to deal with regulatory problems.

Market Failure

- Asymmetric Information
- Moral Hazard Problems
- Banking System and Markets rely on confidence.

Reasons for regulation

- Degree of competition in a market
- Protection of consumers of financial products
- Encouraging small investors
- Capital adequacy of financial institutions
- Ability of small firms to obtain finance
- Preservation of market and practitioner reputation

Collapse of Banking System

- Contagion
- Consumer Protection
- Bank Liabilities form a means of payment => important for economic growth

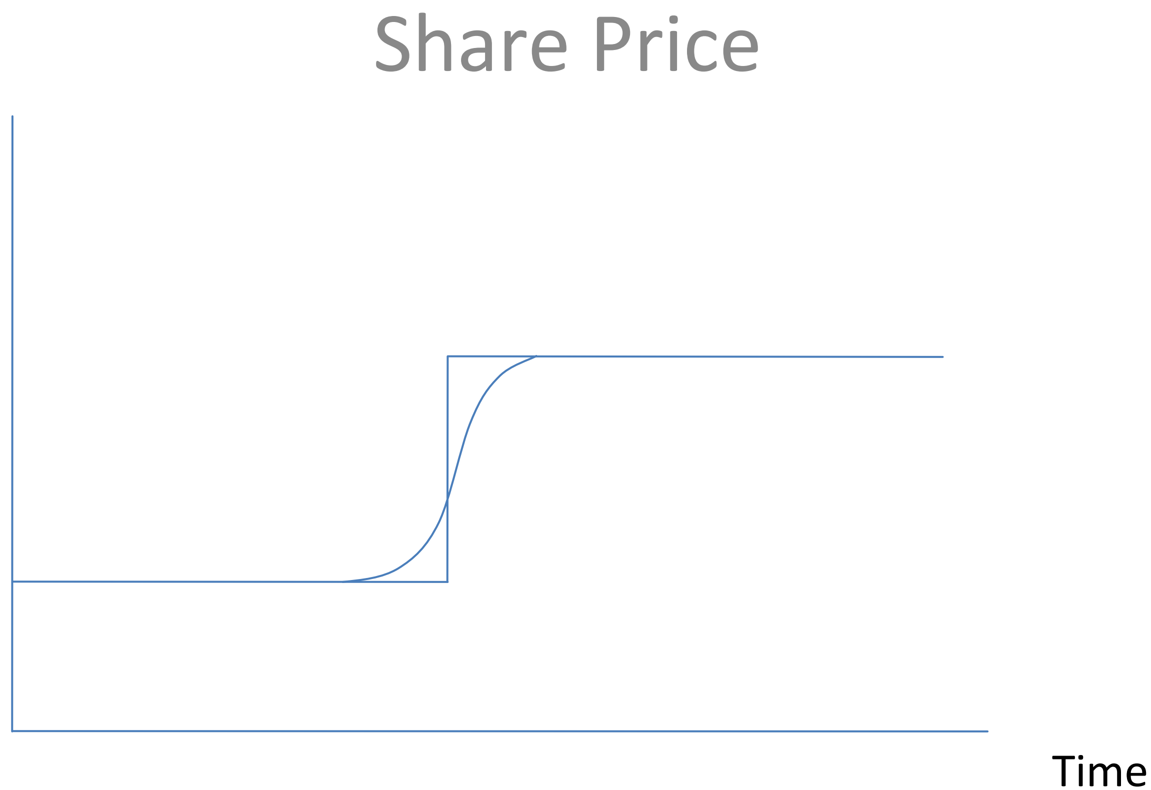
Examples of Financial Market Losers

- Lloyds of London names
- UK Private Pensions
- Split Capital Investment Trusts
- These cases demonstrate mixed attitudes towards losers

FSA

- Set up by the FSMA 2000.
- 4 Major Statutory objectives:
  - market confidence
  - Consumer Awareness
  - Consumer Protection
  - Fighting Financial Crime (Market Abuse, insider trading, market cleanliness: eg Biffa).

FSA tests of Market Cleanliness



Market Inefficiency => possibility of Insider Trading

Theory of Regulation

- Market Failure (asymmetric info/moral hazard
- But: Regulation itself may create moral hazard.
- Agency Capture.
- Compliance Costs
- => increases cost of entry
- => regulation inhibits competition?
- => reduces financial mkt's efficiency to allocate scarce resources.

Deregulation?

- Regulation keeps out new entrants
- Regulation prevents M and A.

Form of Regulation.

- Who should carry out the regulation?
- Government (statutory regulation)?
- Or the financial industry itself (Self-regulation)
- Argument for self-regulation:
- Industry has a commercial incentive to protect its reputation
- Practitioners understand the needs of the industry
- => statutory regulators impose excessive safety standards => higher cost of regulation.

Self-regulation.

- Lighter than statutory regulation
- But awkward half-way house?
- Free-riders may not join industry regulation scheme
- => Must be supported by some govt reg
- Self-regulation and moral hazard/ exploitation of risk (see page 365 – 367)

Financial Regulation in UK

- 2 major reorganisations in a decade
- 1986-1987: Big Bang in Equity markets
- Rapid internationalisation of financial markets
- Financial services act 1986
- Banking Act 1987
- 1998 reforms.

Conclusion

- Financial Services Industry heavily regulated
- Loss of Confidence:
- + Mkt failure => Regulation
- Statutory regulation Versus Self-regulation debate.
- Regulation hindered by single EU financial mkt, globalisation and complex derivatives markets.

Summary of Course:

- Introduction to the Financial markets, the key players and institutions.
- Purpose of FM: efficient transfer of funds from lenders to borrowers => econ growth.
- But: inefficiencies in FM due to moral hazard and asymmetric info.
- FM consist of banking sector, money markets, bond markets, equity markets (and derivative markets).
- Bond pricing and equity pricing: Fundamental value, market value, EMH =>
- DCF models: Supply and demand: price behaviour also affected by psychology: eg bubbles.
- Market failure => need for regulation
- FSA => CBA, market abuse, mkt cleanliness, insider trading, fraud.
- Key question: self-regulation or statutory regulation?