# FINANCIAL MARKETS AND INSTITUTIONS

## FINANCIAL REGULATION

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## AGENDA

- Is regulation needed?
- Regulatory tools:
  - structural supervision
  - prudential supervision
  - distress supervision
- Current and future developments

## IS REGULATION NEEDED?

- Asymmetric information (plus adverse selection and moral hazard) harm financial markets and institutions and the real economy
- Past and current main regulatory responses:
  - "**Structural**" supervision: restrictions on assets, licensing and examination, limits on competition
  - "**Prudential**" supervision: capital requirements, assessment of risk management, disclosures and transparency, consumer protection
  - "**Distress**" supervision: safety nets, intervention and resolution systems,



## SAFETY NETS

- Intermediaries reduce issues linked with asymmetric information through a private market that reduces free-riding issues
- This shifts asymmetric information on depositors that might cause bank runs or volatile deposits
- Safety nets aim at solving this issue:
  - Deposit insurance
  - Government bailouts
  - CB as lenders of last resort
- But safety nets reduce financial development and promote incentives to excessive risk-taking
- Safety nets can be implicit (f.i. too-big-to-fail, cross-sector subsidies, …)

## RESTRICTIONS ON ASSETS

- Main forms:
  - forbidden or limited assets classes (f.i. hedge funds, common stocks, …),
  - minimum requirements (f.i. in high-liquid securities),
  - diversification requirements
- Aim at limiting incentives to excessive risk-taking in high-yield assets, with failures ultimately borne by creditors
- If not well designed, might reduce efficiency of financial markets and provide incentives on arbitrageurs (f.i. govies in banks)



## CAPITAL REQUIREMENTS

- Aim at reducing incentives to excessive risk-taking by having intermediaries risk more of their own money
- Main forms:
  - Limiting leverage (i.e. capital/total sources of funds), that becomes harder when considering off-balance sheet business
  - Checking liquidity constraints: through reaction measures (CFP) or full liquidity requirements
  - Risk-based capital, that proves incentivating for arbitrageurs if too rigid
  - Minimum starting capital: more “structural” than prudential, limits competition

## Resolution and intervention

- Regulatory/supervisory actions need time and proof of need
- Meanwhile, troubled institutions will see their capital reduced and receive more incentives to risk more
- Prompt corrective actions need early-warning systems (f.i. supervisory ladders)
- Intervention at early stages comprises:
  - More frequent supervisory disclosures
  - Submission of restoration plans
  - Restrictions on assets or risk-taking
  - Mandatory transfer of portfolios
  - Supervisory takeover



## Licensing and examination

- Minimum requirements are set on willing-to-be financial institutions:
  - Minimum capital
  - Scrutiny of shareholders' soundness and reputation
  - Limits on particular categories of shareholders (f.i. non-financial borrowing institution)
  - Scrutiny of top management quality, professionalism and reputation
  - Examination of business plans
  - On-site and off-site monitoring inspections

## ASSESSMENT OF RISK MANAGEMENT

- Aim at extending the monitoring to the future by evaluating risk-profiles of entities
- Examinations involve both quantitative and qualitative measures:
  - Quality of governance systems: oversight from BoD and top management
  - Adequacy of policies, procedures, processes and controls on risk-taking
  - Quality of risk measures (f.i. VaR) and monitoring
  - Adequacy of internal controls
  - Stress/scenario testing



## DISCLOSURES

- Requirements to comply with common accounting principles (f.i. IAS/IFRS)
- Provide complete, reliable and material information to markets to receive discipline
- Extend information beyond assets, liabilities, capital, revenues, costs and profit (f.i. risk assessment, governance system, future expectations, …)
- Yet, no single accounting standard exists and controversies surround both cost- and fair-value accounting

## CONSUMER PROTECTION

- Asymmetric information hits consumers as well as markets
- Requires more focus on information and data that can be effectively understood and used by “average” consumers
- For example:
  - Minimum contents and standardised structure of contractual information
  - Full and transparent disclosure of consumer rights on contracts
  - Provision of comparable and standardised measures of cost and risk (f.i. on effective IR)



## RESTRICTIONS ON COMPETITION

- Too much competition incentivises risk-taking and can be disruptive for financial markets
- Reductions in competition increase costs for consumers and reduce efficiency of financial markets
- Solution is puzzling… for example:
  - Minimum starting capital and licensing reduce the number of potential new entrants
  - Resolution systems and safety nets are selective in managing market exit
  - Licensing of branches reduce overcompetition in the same geographical area
  - Controls on M&A limits fears of disruptive appropriation of assets

## REGULATION AND FINANCIAL CRISIS

By reading history, banking crises share something closely linked with regulation:

- all start with financial liberalisation/innovation
- all have weak regulatory systems towards them
- often safety-nets are present, enhancing adverse selection and moral hazard

*"Throughout history, [we had] an extraordinary range of financial crises. Each time, the experts have chimed, "this time is different"*
*[…] eight astonishing centuries of government defaults, banking panics, and inflationary spikes*
*[…] universal rites of passage for emerging and established market nations*
*[…] how little we have learned*
*[…] short memories make it all too easy for crises to recur."*

Reinhart C.M., Rogoff K.S. (2009), "This time is different: eight centuries of financial folly"



## RECENT AND FUTURE DEVELOPMENTS

- Crisis seem to enhance a return to regulation
- The latter is no exception, encompassing:
  - Consumer protection: especially to avoid misselling
  - Extension of resolution and regulation to systemic entities
  - Limits on proprietary trading and engagement in hedge and private equity funds for banks
  - Controls on derivatives, mixing bans, capital requirements, limits on OTC markets, disclosures, …
  - Limits on compensation of top-management
  - Reduction of conflicts of interest in rating agencies
  - Bigger (hopefully also better) capital requirements
  - Struggling for counter-cyclical intervention and the need to reduce arbitrage and efficiency losses