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| IFSS UK Coursework – Financial Regulation, Benefits of Intermediation, and Role of the Central Banks |
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Introduction

As societies and economies progress and become more increasingly modern, the need to have sufficient bodies which regulate the activities of financial institutions increases. While regulation is important, it is also important that these bodies which regulate create a balance so as not to stifle economic growth and progress. Regulation can help overcome some issues that arise from a free market.

Main section

Regardless of area in society we are required to have some form of regulation to ensure that there is as much of a level playing field as possible so that advantage cannot be taken by one party.

Why is financial regulation so important?

Compared to other areas of society, failure in financial services has much more serious implications. This requires regulation to go further than it would usually do in other sectors to ensure that one failure does not have a domino effect of a liquidity crisis or some other form of crisis knocking onto more than one institution. Some of the bodies who impose regulation are the Bank of International Settlements which passes “soft law” that can be adopted by the Financial Policy Committee, and Prudential Regulatory Authority as part of the Bank of England as well as the Financial Conduct Authority, part of HM Treasury.

These bodies intend to use this prudential regulation in order to mitigate as much as possible against a couple of problems as Ford (2015) stipulates Power has passed to the regulators. They lay down the law in banking boardrooms, prescribing not only how financial institutions conduct themselves, but also the type of risks that they should run.

These problems are the externalities problem, asymmetric information, the moral hazard problem and principal agent problem. The externalities problem concerns the effect of a crisis within a financial institution has on the environment around it such as causing further crises across the wider economy. The asymmetric information problem is where directors and managers have better knowledge on company than potential lenders or investors which could mislead these parties. This could also take the form of insider dealing where critical information known to insiders of a company is used to benefit those in the know. Countries have laws against this. The moral hazard being encouraged to take more risk than is necessary due to there being safety net “compensation” in event of failure. The principal-agent problem directors and manager agents of shareholders but might choose to work to their own targets which might involve having to take more risk at the expense of shareholders.

As a result of the issues above prudential regulation is imposed through various means one of which is capital adequacy.

Capital adequacy ratio relates to the amount of capital funds that a financial intuition holds “in reserve” so that should there be a crisis or the value of the institutions assets fall dramatically, then the institution has enough “reserve” to fall back on. The current minimum capital adequacy ratio for a financial institution in the UK as per the Bank of England (2015) is to be 11% of risk-weighted assets. This means that institutions are required to hold 11% of the value of their assets value (mortgage loans, etc.) in the form of capital as opposed to liabilities such as short term deposits.

If the problems discussed above are not controlled then this can lead to financial institutions becoming reckless which could lead to their downfall and leads to a larger distrust of the financial services sector generally. We see examples of this recklessness through things like inappropriate selling of financial products or services such the incident described by McCormick, M., & Binham, C. (2019) The Financial Conduct Authority levied a £29.1m fine on Carphone Warehouse….after the mobile-phone retailer mis-sold its “Geek Squad” insurance and technical-support product . Another example of recklessness is fines which are issued for breaches of sanctions placed onto financial institutions. Yet another example of recklessness is having anti-money laundering processes which are not sufficient enough to stop these crimes being committed using financial institutions as laid out by the Financial Conduct Authority (FCA) (2019) The FCA found serious and sustained shortcomings in Standard Chartered’s AML controls relating to customer due diligence and ongoing monitoring….Standard Chartered’s agreement to accept the FCA’s findings meant it qualified for a 30% discount. Otherwise, the FCA would have imposed a financial penalty of £145,947,500. add to this the events as described by Jenkins (2012) HSBC is braced for a settlement with US regulators that could top $2bn….from its involvement in alleged money laundering and other rule breaches.

Prudential regulation, however is not the only type of regulation which is imposed on financial institutions.

How does it differ from “ordinary” regulation?

There are more examples of other types of regulation which cannot be escaped structural regulation and investment protection.

Structural regulation differs from prudential regulation as is sets physical limits onto the affairs of financial institutions, dictating which services that they can offer, products that they can sell to customers and exactly where they are allowed to do business described by Ford (2015) Banks can do little without regulatory blessing. They cannot buy and sell subsidiaries or launch new products….its financial policy committee can step in and curb how many loans of a certain type they can sell. This idea of restriction on trade is much like the regulation around the licensing of alcohol sale as the UK Government (2005) allude to Licensing (Scotland) Act 2005 63 Prohibition of sale, consumption and taking away of alcohol outwith licensed hours

(1)Subject to subsection (2), a person commits an offence if, outwith licensed hours, the person—

(a)sells alcohol, or allows alcohol to be sold, on licensed premises,

(b)allows alcohol to be consumed on licensed premises, or

(c)allows alcohol to be taken from licensed premises. that restricts the activities of licensed premises as to the timing of which they are allowed to sell alcohol. As with institutions which break regulation in a financial setting, there are also fines for breaching alcohol legislation however these are smaller in comparison as alluded to by the UK Government (2005) A person guilty of an offence under this section is liable on summary conviction to a fine not exceeding level 3 on the standard scale.

Investment protection (conduct of business) also differs from prudential regulation as this covers measures designed to protect investors from events such as mismanagement of funds, incompetence, malpractice and fraud. Some examples of this idea outside of financial services are things which are designed to protect consumers such as health and safety legislation as stated by Tesco PLC (2015) Our own standards exceed basic legal requirements to ensure that no-one is exposed to injury or harm. as well as food standards also alluded to by Tesco PLC (2015) Our customers expect us to only sell products made to the highest quality and they trust us to ensure that all our products are safe and comply with all applicable laws and regulations.

Conclusion

While having competent and robust regulation in place is important as set out above, it is also important that this regulation seeks to strike a balance between penalising where appropriate and allowing the market to be as free as it possibly can. This is to ensure that the financial services sector can still function and grow exponentially without fear of plateauing or conceding business due to over-regulation which could lead to a less stable marketplace that would be less favourable to every institution operating within its reaches.

Word count (without headings): 1,189

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B. What are the main benefits of financial intermediation and how do these benefits arise, that is, what functions of intermediaries lead to these benefits?

Main benefits:

* Financial intermediaries should provide a platform which promotes lending with sufficient liquidity, safety and simplicity behind the lender which is not the case in direct lending.
* This solve the issues which are presented by direct lending in the form of matching savers and borrowers. This allows borrowers to achieve their desired loan maturity and desired loan amount, as well as sufficiently reducing the risk that the lender might not receive repayment of the loan, and finally allowing borrowers to borrow funds from savers in a different geographical location.

How they arise:

* Financial intermediaries can write financial claims onto themselves from savers funds so they can take on further investment in the form of marketable claims or to lend to borrowers which can ensure that there is sufficient liquidity in the institution.
* Key concepts involved in reconciliation needs which are undertaken by financial intermediaries are maturity transformation, described by Shubber (2016) as borrowing short and lending long, deposit aggregation and risk transformation in the form of diversification.
* As described above maturity transformation is where deposit taking financial intermediaries transform short term deposits into long term loans. This usually requires short term deposits to keep being taken.
* Deposit aggregation is where deposit taking financial intermediaries can group or “aggregate” together smaller deposits from savers in order to loan a larger amount to borrowers
* Risk transformation is the idea that the saver is not the principal, instead this is the financial intermediary. This means that the intermediary carries the risk of non-repayment from the borrower. As a result the risk is transformed by the institution through diversifying the types of loans that they make to borrowers.

Conclusion:

* Financial intermediaries provide a key role in solving issues with direct lending and there are a number of ways that they can do this which cannot be done by surplus and deficit units alone.

Word count (without headings): 304

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C. Describe the role of central banks, with particular reference to the Bank of England.

Supervisor

* In the UK economy the Bank of England is the main overseer of the activities of financial institutions as the Bank of England (2020) describes its role in this regard as Our Prudential Regulation Authority regulates and supervises all the major banks, building societies, credit unions, insurers and investment firms in the UK.

Monetary policy

* The Bank of England also sets the monetary policy across the UK economy. This is a critical role. The Bank of England have a committee which meets regularly to set interest rates with the view to this enabling inflation targets to be met.

Issuing notes

* Another role of the Bank of England is issuing bank notes as the Bank of England (2020) describes Only we can issue banknotes in England and Wales. Other banks can issue banknotes in Scotland and Northern Ireland. which they justify by stating that they are trustworthy though being difficult to forge.

Governments bank

* Being the bank which the government interacts with is also another role of the Bank of England. Part of its responsibilities in relation to this is that it maintains the Exchequer’s account which include revenue streams such as those operated by HMRC (income tax etc.) and also the spending streams.

Banker to other banks

* Finally, the Bank of England is a bank which interacts with commercial banks and building societies. These institutions, if they have assets over £600m, are required to deposit assets worth 0.18% of their deposits in the Bank of England. It is also a lender of last resort to these institutions in case of crisis where commercial banks and building societies can call upon its reserves to ease the crisis.

Conclusion

* The Bank of England undertakes many roles which are vital to ensuring that the economy of the UK functions and does so well. Without being prudent in itself these roles would be incredibly difficult to manage as efficiently as it does.

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