AcF 304 End Term Test

WEEK 17 (included) - As per your timetable - test on module Moodle page

50 Multiple Choice Questions in 60 minutes - Random questions for each student from a large bank of questions.

- If you have any technical difficulties – in order for the university to try and assist you…
- Email: ugaccfin_office@lancaster.ac.uk

- **during** the exam – NOT 30 minutes afterwards

- provide photo evidence of any problems with your email

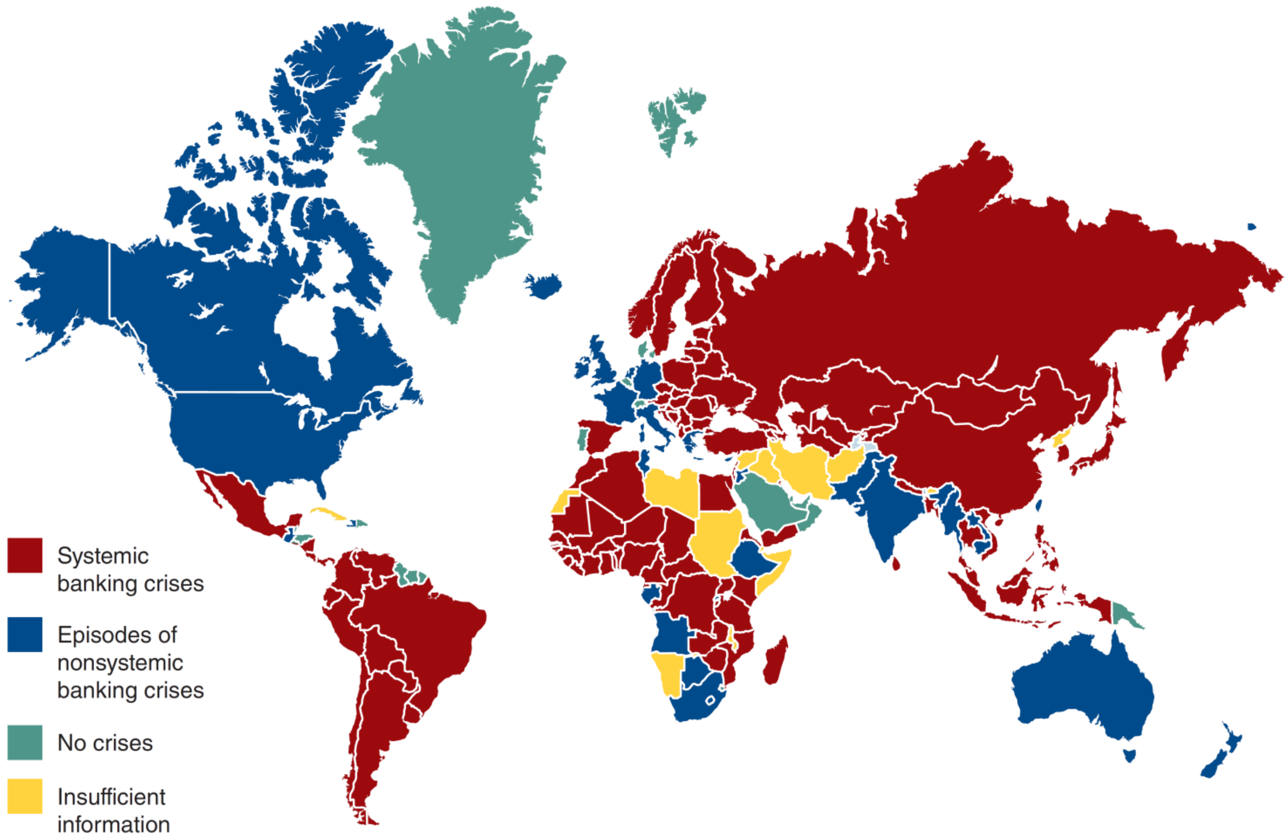
- Good luck!

AcF 304 Financial Markets

Topic 3: Why Do Financial Financial Crises Occur and Why Are They So Damaging to the Economy?

Part 2 – Regulatory Response to Financial Crisis

Figure 18.2 Banking Crises Throughout the World Since 1970



Source: Luc Laeven and Fabian Valencia, “Systemic Banking Crises Database: An Update,” IMF Working Paper No. WP/12/163 (June 2012).

Such Financial Crises leads to two things…

- A strengthening of financial institutions internal controls i.e., Risk Management

- Financial Regulation

Securities Act of 1933

- The Securities Act of 1933 was enacted by Congress in 1934 during the Great Depression and after the stock market crash of 1929
- The 1933 Act was the first major federal legislation to regulate the offer and sale of securities
- The act took power away from the states and put it into the hands of the federal government
- The act also created a uniform set of rules to protect investors against fraud

Not Assessed

The Regulatory Response to the Financial Crisis 2008

- Dodd – Frank
- Basel 3
- MiFID 2
- *Note: There is no similar regulatory response to the 2020 Financial Crisis since a) we have recovered b) it was not an asset bubble crisis driven by security innovation/ speculation/ excessive lending*

The Regulatory Response to the Financial Crisis - Dodd Frank (US)

- The Dodd–Frank Wall Street Reform and Consumer Protection Act (commonly referred to as Dodd–Frank) was signed into United States federal law by President Barack Obama on July 21, 2010.

- It brought the most significant changes to financial regulation in the United States since the regulatory reform that followed the Great Depression.

US Regulation Reason: Ensure Soundness of Financial Intermediaries- Dodd-Frank (2 of 2)

From a financial market / investment banking perspective 2 highlights:

- Comprehensive regulation of financial markets, including increased transparency of derivatives (bringing them onto exchanges)
- The Volcker Rule - prohibits depository banks from proprietary trading

Such regulations restricted the activities and profitability of Investment Banks

TRUMP INFLUENCE

On May 22nd 2018, Donald Trump signed into law an easing of such financial regulations and reducing oversight for banks with assets below $250 Billion

→ SVB was one of the deregulated banks

This move from increased regulation after a crisis to deregulation during an economic boom has been a recurrent feature in the United States.

Dodd-Frank Makes Your World A Safer Place and How Trump Changed That

Donald Trump targeted de-regulation by

- reduce capital ratios
- revisit measures banning risky trading
- reduce consumer protection

This led to US Bank shares outperforming other US equity sectors 2017-2019!

Ensure Soundness of Financial Intermediaries – *Basel 3* – *International* (1 of 3)

The Basel Committee on Banking Supervision

- Goal:To steer the financial industry, and especially banks, away from the practices that led to the 2008 Financial Crisis

  = Higher Capital Requirements

- Financial institutions must set aside (safe) capital against risky activities
- Capital includes cash deposits or short term T-Bills
- Risky activity might include making a 30-year loan to an institution or owning a 30-year maturity corporate bond

Ensure Soundness of Financial Intermediaries – *Basel 3 – International* (2 of 3)

Higher Capital Requirements

- If the capital requirement for a bank holding a 30-year corporate bond is 3% for every 100MM bonds it owns it must set aside 3MM in capital
- If capital ratios are raised to 6% for every100MM bonds it owns it must set aside 6MM in capital
- Therefore, raising capital ratios restricts the ability of a financial institution/investment bank to do business!
- The accord aims to prevent banks from hurting the economy by taking more risks than they can handle.

This can lead to a market liquidity problem which is exactly the problem today in Corporate Fixed Income Trading – Topic 3 – Part 3

Basel 3 …obviously it's a lot more complicated than this but let's just concentrate on the higher capital requirements we have just discussed (3 of 3)

PILLAR

- **PILLAR 1** – Enhanced Minimum Capital & Liquidity Requirements
- **PILLAR 2** – Enhanced Supervisory Review Process for Firm-wide Risk Management and Capital Planning
- **PILLAR 3** – Enhanced Risk Disclosure and Market Discipline

REGULATORY ELEMENTS

- **Higher Tier 1 and Tier 2 capital requirement** – This serves as a buffer to absorb shocks during a financial crisis.
- **Capital Conservation Buffer** – This is mandatory additional capital that is required to be hold over and above its minimum capital requirement.
- **Counter Critical Measures** – There are regulations used to deal with cyclical changes in the balance sheet of banks.
- **Liquidity Standards** – Liquidity Coverage Ratio and Net Stable Funding Ratio are the two liquidity standard ratio being mandated.
- **Capital Leverage Ratio** – This is used to determine capital adequacy of banks. It also puts a constraint on how the bank may leverage its capital.

Not Assessed

Oh!…and there is a Basel 4

The Regulatory Response to the Financial Crisis – MiFID2

Markets in Financial Instruments Directive – EU / UK

- *Implemented Jan 2018*
- *1.7 million paragraphs*

Key themes

- Price Transparency
- Research Unbundling

The Regulatory Response to the Financial Crisis – MiFID2

Price Transparency

- Making prices of securities (esp FX, Bonds & Derivatives) more visible to clients ‘pre’ and ‘post’ trade.
- Pre-trade transparency - trading venues and market-makers to publish offered, executable quotes before a trade is complete
- Post-trade transparency - all trades must be immediately included in a trade report. Such trade report, containing the volume and price must be published to the market. Post-trade transparency requires the timely publication of trade data to an Approved Publication Arrangement (APA). *
- *Exceptions for large size trades

The Regulatory Response to the Financial Crisis – MiFID2

Research Unbundling

- The Sell Side can no longer provide research for free to the Buy Side.

The way it used to work…

- The Sell Side provided research for free to the Buy Side
- The Buy Side paid the Sell Side in Trade Flow

i.e., For Deutsche Bk research, Buy Side executes multiple equity Sell orders with DB traders e.g., Fidelity AM sells 200,000 BP shares at 100 pence per share

The Regulatory Response to the Financial Crisis – MiFID2 – Research Unbundling

For Deutsche Bk research, Buy Side executes multiple equity Sell orders with DB traders e.g. Fidelity AM sells 200,000 BP shares at 100 pence per share

- What if the best Sell / Bid price in the market was 101 or 102?
- Fidelity has not provided 'Best Execution' and the end customer i.e., you & me, has been 'cheated'!

The Regulatory Response to the Financial Crisis – MiFID2 – Research Unbundling

Research Unbundling means

- Sell Side can no longer provide their research to the Buy Side for free (and expect to be paid in Trade Flow) i.e., they must charge fees for research

Who pays for the research – the Fund Manager or the Fund Manager's clients ???

- Buy Side e.g., Blackrock must deal at the best price in the market and show 'Best Execution'

Reading:"FCA finds MiFID II research unbundling rules working well for investors"

https://www.fca.org.uk/news/press-releases/fca-finds-mifid-ii-research-unbundling-rules-working-well-investors#webform-submission-page-feedback-form-node-59661-add-form

MiFID2 – Research Unbundling Other Consequences

- If a Fund Manager was receiving research from 50 Investment Banks for 'free' pre MIFID2…now that might be 5-15 banks

- Fund Managers now do more of their own research *(Research career prospects better on Buy Side?)*

"Asset managers to slash sell-side research after MiFID II, survey shows"

https://www.reuters.com/article/uk-eu-mifid-research/asset-managers-to-slash-sell-side-research-after-mifid-ii-survey-shows-idUKKBN1DK1SL?edition-redirect=uk

AcF 304 Financial Markets

Topic 3: Why Do Financial Financial Crises Occur and Why Are They So Damaging to the Economy?

Part 3 – The Impact of Regulation on the Fixed Income Market

Basle 3 "This can lead to a market liquidity problem which is exactly the problem today in Investment Banking Corporate Fixed Income Trading"