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Strategies of Financial Regulation

Financial Regulation

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Today's class

- Market failures (review)
- Objectives of FinReg (review)
- **Strategies of FinReg**

Market failures in financial systems (Review)

- Asymetric Information
- Negative Externalities
- Positive Externalities and public goods
- Imperfect competition
- Behavioral biases

MF - Asymetric Information

- Intertemporal transactions between well-informed sellers and inexperienced buyers
    - Market signals may be weak, failing to ensure reliability of investments
    - Adverse selection (Akerlof)
        - "I refuse to join any club that would have me as a member" (Groucho Marx)
- Financial products as credence goods:
    - Search goods X Experience goods X Credence goods

MF - Negative Externalities

- The financial system is deeply interconnected with other markets
  - The financial fulfills a structural role for the economy as a hole (domino effect)
    - Provides a system of payments
    - Expert selection and monitoring of business projects for financing
- Thus, financial crises can produce several negative externalities
  - In theory, under the assumption of low transaction costs, these effects could be internalized by private actors through negotiation (Coase)
  - But transaction costs are high: the market is composed of many actors and sources of riks are difficult to pinpoint
    - Systemic failures: bank runs, financial crises

MF - Positive Externalities and public goods

- Example of a public good produced by the financial market:
    - provision of a payments system
- Free rider problem: suboptimal level of investment in public goods due to revenues that fall short of the benefits the activity generates for society
- Different possible solutions:
    - direct intervention by the State,
    - subsidies from private and public sources,
    - concession of the right of monopoly.

MF - Positive Externalities and public goods

- A theoretical problem: market failure or stabilization mechanism
- Do we want banks to be small? Should starting a bank be easy?
- Rules that constrain access (entry) in financial markets
  - Barriers to entry that reduce competition

MF - Behavioral biases

- Financial products and services are particularly susceptible to behavioral biases
  - Endowment effect, sunk costs and loss aversion: why we believe the price of our stock will go up?
  - Hiperbolic discounting and intertemporal choices: do we understand how interest rates work?
  - Framing effects: do we know what we are choosing?
- Behavioral biases make regulation a much harder problem
  - Market signals and economic parameters lose their meaning, as they do not reflect the real preferences of consumers

Objectives of financial regulation (Review)

- Protecting investors and other users
- Protecting consumers in retail finance
- Protecting financial stability
- Promoting market efficiency
- Promoting competition
- Preventing financial crime
- Other objectives...

OR - Protecting investors and other users

- Protection of investors
    - Example: rules the impose disclosure requirements in securities transactions
    - Attempts to address asymetric information and adverse selection
- Protection of clients/customers of investment firms
    - Risk that the firm may make poor investment choices for their client/customer
    - **Agency problem**: investment firm activities are difficult to monitor -> risk of opportunistic behavior
- Reduction of risks in relation to financial intermediaries (banks, insurance, etc)
    - Again, agency problems may lead to systemic risks

OR - Protecting consumers in retail finance

- Based both on information asymmetry and behavioral concerns
- Wider definition of objectives (example: financial education)

OR - Protecting financial stability

- Domino effect and the negative externalities of systemic financial failure
  - Bank runs, financial crises, etc
- Systemic risk → prudencial regulation

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OR - Promoting market efficiency

- Crucial role of secondary markets for efficiency
    - They increase the liquidity of assets
    - Thus, they also reduce the risk, *ex ante*, for investments, reducing the costs of capital deployment
- **Informational efficiency**: accuracy and speed with which financial markets respond to new information
    - Increases flexibility and price adaptation, making the market more responsive and assets more liquid
    - Role of regulation: to facilitate and promote the dissemination of knowledge and information to increase informational efficiency

OR - Promoting competition

- Typically this is not the function of a financial regulator (Bacen x CADE)
- A significant change in the UK
    - Creation of the Competition and Markets Authority (CMA), as a pro-active governmental body to increase competition
    - Creation of "Regulatory Sandboxes" as a new institutional tool
    - Open finance: data sharing to reduce competitive advantages of large banks and thus reduce barriers to entry
- Echos in Brazilian financial regulation
    - Recent measures by Bacen to promote competition: Open banking, fintechs, PIX
- EU: increasing competition by reducing transnational barriers

OR - Preventing financial crime

- use of financial services by criminal organizations (money laundering, terrorist financing);
- payments designed to influence a decision-maker improperly (bribery, corruption);
- payments associated with trade in prohibited goods (such as slavery, weapons, endangered species);
- use of the financial system to hide assets from tax authorities and creditors.

OR - Other Objectives?

- Many other objectives may be found
- In general they relate to the main economic purposes of the financial system: leveraging economic resources and transferring excess of capital to foster new economic activity.
- **Regulatory objective function**: goals in tension, how to prioritize?

Strategies of financial regulation

- Entry regulation
- Conduct regulation
- Information regulation
- Prudential regulation
- Governance regulation
- Insurance
- Resolution

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Table 3.1 Strategies of Financial Regulation

Scope of obligations: **Regulatory strategy**	**User**	**Firm**	**Sectoral**
Ex ante strategies			
Entry regulation	Participation Profiling	Licensing Qualification requirements Product regulation Structural restrictions	Market power
Conduct regulation	Trading rules	Trading restrictions Conduct of business	
Information regulation	Education	Disclosure	
Prudential regulation		Balance sheet	Macroprudential
Governance regulation		Board structure Compensation regulation Risk management Ownership restrictions	
Ex post strategies			
Insurance	Insurance	Lender of last resort Bail-outs	Lender of last resort Bail-outs
Resolution		Resolution procedures	

SR - Entry regulation

- **User**: restrictions on participation on specific transactions (only "sophisticated" investors)
- **Firm**:
  - **Licencing**: regulators must grant prior approval (under certain conditions)
  - **Qualification requirements**: including identity of owners (to weed out fraud)
  - **Product regulation**: restrictions on contractual terms and products offered
  - **Structural restrictions**: limitations on scope and activities, to reduce systemic risk, such as separation of commercial and investment banking
- **Sector**: Market power considerations (because of potential barriers to entry)

SR - Conduct regulation

- **User**: trading rules, restricting manipulating the market and leveraging insider information
- **Firm**:
  - **Trading restrictions**: again, rules to prevent market manipulation and usage of insider information
  - **Conduct of business**: very important, they establish a basis for business practices relating to:
    - dealing with clients (marketing, advertising, and sales techniques);
    - handling client's assets (custody segregation requirements);
    - management of conflicts of interest by financial firms.

SR - Information regulation

- **User**: recipient of educational content (financial education)
- **Firm**: various forms of disclosure regulation
    - mandatory pre-contractual disclosure;
    - periodic, and event-driven disclosure requirements on issuers of securities;
    - obligations on financial firms to report details of their balance sheets and investment strategies to regulators.

SR - Prudential regulation

- **Definition**: Restrictions on how financial firms shall manage their assets and liabilities in order to constrain risk.
- **Firms**:
    - minimum level of assets (in relation to liabilities)
    - requirement that a certain proportion of asset holdings must be liquid
    - direct restrictions on the riskiness of investment and insurance firms' asset portfolios
        - prohibitions on the purchase of particular asset classes
        - procedural obligations regarding portfolio management and risk allocation

SR - Prudential regulation (cont)

- **Sector**: macroprudential regulation
    - **Logic**: Interconnectedness of firms’ assets and liabilities affect the stability of the system as a whole
        - Post-2008: previous approach was not enough
        - New Basel recommendations
    - **Instruments**: restrictions on firms, classes of firm, or whole sectors, according to how investment strategies inter-relate

SR - Governance regulation

- **Firm**: “Corporate governance”
    - rules about executive compensation, board structure, and directors’ duties for financial firms
        - PS. Corporate governance has implications for financial stability (incentives regarding trading behavior)
    - specific rules for mergers and acquisitions
        - PS. Acquisitions in the financial sector affect both competition and financial stability

SR - Insurance

- **User**: investor/depositor insurance regimes
- **Firms**:
    - Lander of Last Resort (LOLR)
        - Central Bank provides emergency liquidity assistance (cash)
        - Central Bank restructures the balance sheets of entities, landing against inferior collateral (asset insurance)
- **Sector**:
    - Lander of Last Resort (LOLR)
    - Bail-Outs (form of ‘capital insurance’ for financial firms, taxpayer effectively insures investors in the troubled firm)

SR - Resolution

- **Firm**: Act more quickly and effectively than ordinary insolvency law so as to avoid loss of value in the event of bank failure
    - Introduces private capital to troubled firms, in place of state support through:
        - sale to a competitor (who becomes the effective insurer o liabilities),
        - automatic reduction of liabilities (creditors take the loss).

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Let's connect it all..

Market Failures

Asymetric Information
Negative Externalities
Public goods
Imperfect competition
Behavioral biases

Objectives

Protecting investors/users
Protecting consumers
Financial stability
Market efficiency
Competition
Preventing crime

Strategies

Entry regulation
Conduct regulation
Information regulation
Prudential regulation
Governance regulation
Insurance
Resolution