Intro

Market failure is when the price mechanism fails to efficiently allocate resources in the financial industry. An example of when market failure has occurred in history is the Financial crisis. Due to the high levels of sub prime loans being given out by financial institutions, such as the Lehman Brothers, and the fact that interest was rising higher then income at the time, the loans became un-payable. People became unable to pay off their loans and banks lost out on the substantial amount of loans that they had given out leaving them bankrupt. Stemic risk arose, from the interdependence of banks, this meant that when the Lehman Brothers financial institution went bankrupt, it affected banks globally, European banks were hit the hardest with this.

why it happened, global impact, exchange rate

Excessive high risk lending is one cause that can affect the market failure of the financial sector. When banks give out loans to unreliable candidates they risk going bankrupt because they give out loans to people who may not pay it off. Unfortunately, banks rely on the government at times like these to bail them out when a loan that was given out has not been paid back. Since eternal parties bare the risks of the banks decisions, banks become more likely to to make decisions in the hopes of maximising profit because they know that they do not suffer the loss of an unpaid loan. This is known as moral hazard and happens when banks think they are ‘too big to fail’. The Lehman Brothers financial institution, created a moral hazard in 2008 by giving out loans which they relied on the government to cover when the loans were not paid back.

Asymmetric information plays a critical role in the market failure within the financial sector because it shows a lack of regulation. The uneven division of information between two parties in the financial sector may occur with the bank and the individual or company they are lending to because the individual asking for the loan will have more of an idea about how likely they are to pay the loan bank even with a change in interest rate. The bank and regulators also show a distribution of asymmetric information among themselves because when a bank gives out a loan they will know how risky that loan is however they can hide this information from regulators to make their balance sheet appear stable. This is problematic because regulators are then unable to hinder banks giving out risky loans because of the negative externalities that arise from the abuse of risky lending decisions.

One way that the government could reduce the affects from risky lenders is by strengthening regulations. Ever since the financial crisis an institution called The Basal Committee on Banking systems (BCBS), provided a framework

1st para

point: high risk lendning, lack of regulation, and credit checking, led mortgage burst = euro crisis. countries like italy and greece have not revovered, standard of living has fallen. worse then great depression

2nd para

moral hazard