12M015

Regulation of Financial Markets

3 ECTS

1- SUBJECT DESCRIPTION

Financial markets regulation is an ever-present element in daily life of banks, securities market, stock exchanges, companies with equity or debt publicly traded, or persons related in one way or another to the financial markets and their entities. What happens in financial markets and to financial institutions is directly conditioned by existing and forthcoming regulation, and failure to adapt to or comply with its dictates might bring about severe consequences for the markets and the economy at large, as well as for the persons (physical or legal) that might be subject to severe economic, civil and even criminal proceedings for non-compliance.

As an academic discipline, financial markets regulation has traditionally attracted –with the exception of quite specialised programmes in business schools- little attention in most programs of economic and financial schools, with the result that many professionals joining the financial markets ranks are ill-equipped to deal with issues which are suddenly perceived as strongly conditioning their work. In this course we will try to give the basic elements of understanding of this regulation and its subsequent supervision and enforcement, so that students having completed it will be able to understand and deal with most of those issues.

The course will focus on the economic principles underlying the regulation and supervision of the financial sector and its evolution over time, starting with some of the failures or exceptions of the model of perfect competition when applied to the financial sector. It will also analyze those elements of financial markets that set it aside from other regulated sectors in the economy, and which are directly associated with the crucial role of the financial sector, in particular banking, in the organization of human life and relationships.

We will examine in some detail the different pillars of financial sector regulation: prudential, information disclosure, conduct of business rules, and financial stability, and their different translation into the regulation and supervision of different pieces of the financial markets structure: banking, securities and financial products, derivatives and equity markets, etc.

While prudential regulation and supervision (or, more generally, all those elements designed to prevent or contain the failure of financial entities and the financial system) constitute always the core of any financial markets regulation program, we will in this course devote also attention to the economic foundations of conduct of business rules (including but not limited to disclosure, transparency, know-your-client rules, etc.). This is because failures in the conduct of business rules greatly undermine the confidence necessary to sustain the financial system, and might have devastating effects other than those inflicted directly on clients, with the potential of endangering the whole financial system.

Particular attention will be devoted to a number of issues raised in the last decade of the 20th century extending to the present days. We will review the deep de-regulatory process undergone throughout that period along with the generalized de-regulation of the economy, its effects, and the movement towards re-regulation and enhanced supervision underway at present.

We will finally address some current topics and challenges in regulation which have captured the public eye in the recent years along with the deep financial crisis of the first years of this century due to the social impact of the issues underlying them: role of rating agencies and regulation of their activity; benchmarks (in particular interest rates), their use and how to avoid their manipulation; and some case examples of failure in regulation or lack of compliance with it (like market manipulation, insider trading, front running, or gross violation of the codes of conduct), its consequences and how to detect and deter them. Most of the topics of this course will be developed with the support of specific and practical case examples chosen from real world situations of present day financial sector.

2- OBJECTIVES

The objective of this course, as mentioned above already, is to provide a sound background and well-founded knowledge of the fundamentals of financial markets regulation, its importance, effects in the economic sphere, and the problems that originate when regulation is either ineffective or not complied with.

The course´s structure comprises 6 sections:

- Economic foundations of financial markets regulation
- Historic overview
- Banking regulation
- Securities markets regulation
- International and multi-lateral organizations in financial markets and banking regulation
- Case examples of regulation, failures, non-compliance and its analysis and detection

3- METHODOLOGY AND WEIGHTING

Classes

Lectures are necessary to explain the course's basic content and concepts. Even though the professor has the main role in presenting the material, interactions between professor and students and group discussion will be strongly encouraged. The class will employ the professor's own writings in class as well as PowerPoint projections in some cases to cover the content of the program. Students are encouraged to do the recommended readings before or attending each theory class.

Practical work

To gain a better understanding of the matters covered in class, students will practice by way of one individual Assignment in which students will be tasked with developing individually a topic pertinent to the course syllabus: defining the topic and its focus, finding sources of information, developing the reasoning or explanation of the topic, its conclusions, etc. Time permitting students will make a presentation of the assignment to the class or to the professor.

Final Grade

There will be ONE final exam that will cover all the topics seen in class. The final exam will consist of some short/medium length answer questions, and a little essay, and the result of the exam will count 50% towards the final grade. The group assignment and its presentation will count another 30% towards the final grade. Participation in class will count the remaining 20% towards the final grade.

Class Attendance

Regular attendance is required in order to receive credit for class participation.

4- CONTENT

Below there is a general description of the material covered in lectures and a tentative distribution of it along the 5 sessions (4 hour each)

SESSION 1

1.1. ECONOMIC FOUNDATIONS OF REGULATION

Imperfections of and/or exceptions from the model of perfect competition when applied to the financial system

- Asymmetric information (adverse selection and moral hazard)
- Non appropriability of information
- Public goods
- Externalities
- Other objectives of policy

What makes financial markets so different from other markets (in particular the role of money and banking in all aspects of human life) and sustains a specific, well-differentiated regulatory and supervisory structure

- ✓ *Frederic S. Mishkin: The Economics of Money, Banking and Financial Markets. 10th edition (2013). Pearson (Chapters 2 and 12)*
- ✓ *Randall Dodd: The economic rationale for Financial Market Regulation. December 2002. Financial Policy Forum, Derivatives Study Center*

1.2. BRIEF HISTORY AND GOALS OF FINANCIAL REGULATION

History:

Some specific regulations and measures adopted throughout history (deposit guarantee, lender of last resort, portfolio restrictions and geographic limitations, limits on interest rates, etc.). Potential adverse effects derived from the adoption of these measures.

- Basic banking regulation until early 20th century
- Securities Act of 1934 as a reaction to the Great Depression of the 1930s
- The “European model”
- The generalized de-regulatory and self-regulatory process
- Re-regulation as a response to the financial crisis of the early XX1st century

Goals:

- Efficiency in market organization
- Integrity in financial markets transactions (conduct of business rules) and in the relationships between financial entities and their clients and among themselves.
- Solvency of the financial system
- Monitoring the stability of the financial system

- ✓ *Matthew Sherman: A short history of Financial Deregulation in the United States. July 2009. Center for Economic and Policy Research, Washington D.C*
- ✓ *Dirk Heremans, Alessio Paces: Regulation of Banking and Financial Markets. April 2011, Rotterdam Institute of Law and Economics*
- ✓ *Professor's notes previous to class.*

SESSION 2: BANKING REGULATION

Protective measures (ex –post):

- Deposit guarantee
- Lender of last resort
- other

  Preventive measures (ex- ante):

- Entry barriers, restrictions on activity and geographic limitations
- Interest rate restrictions
- Licensing and suitability checks

  Prudential regulation: Capital adequacy rules as the safeguard against potential losses and as a form to limit the excessive assumption of risk by bank managers

- Definition of regulatory capital and its classes
- Regulatory capital for credit risk, market risk, operational risk and others.
- Liquidity and leverage ratios
- Asset eligibility in computing regulatory capital
- Bank equity as a guarantee of prudency. Requirements on the ratio debt/equity to control banks' risk.

  Basel capital agreements: from Basel I to Basel III:

- Minimum capital standards for credit risk, market risk and operational risk
- Liquidity and leverage ratios
- The 3 Pillars of Basel: Minimum capital requirements, Supervisory review process, and Market discipline
- Macroeconomic impact of Basel capital agreements
- Adoption of Basel Agreements by the European Union
- Thorough review of the world's banking regulation as a follow up to the world financial crisis (Vickers report in the UK, Dodd-Franck Act and its Volcker Rule in the USA, etc.)

✓ *Frederic S. Mishkin: The Economics of Money, Banking and Financial Markets. 10th edition (2013). Pearson (Chapter 12)*
✓ *Dirk Heremans, Alessio Paces: Regulation of Banking and Financial Markets. April 2011, Rotterdam Institute of Law and Economics*
✓ *Basel Committee on Banking Supervision (www.bis.org)*
✓ *European Banking Authority (www.eba.europa.eu)*

SESSION 3: SECURITIES MARKETS REGULATION

Basic concepts: Disclosure, transparency, and conduct of business rules

- Primary markets
  a. Regulation of information contained in prospectuses, accounting standards, relevant information, shareholding, etc.
  b. Credit rating agencies regulation
  c. Regulations applicable to managers and administrators of publicly listed companies
  d. Corporate governance

- Secondary markets
  a. Regulation of exchanges,
  b. Self-regulation
  c. Prevention and detection of market abuse and price manipulation
  d. Insider trading and other financial markets abuses (front running, etc.)

- Investment Services Firms
  a. Regulation of conduct with the clients and in the markets
  b. Front-running and client discrimination
  c. Review of practices designed to alter the orderly functioning of markets

d. Prudential measures applied to financial intermediaries
e. "Know your client" rules, assessment of suitability and convenience of investments offered to clients, fair treatment, disclosure of information provided to clients, advisory services, …

- Regulation of Collective Investment Vehicles:

✓ *Frederic S. Mishkin: The Economics of Money, Banking and Financial Markets. 10th edition (2013). Pearson (Chapter 12)*
✓ *IOSCO: Objectives and principles of securities regulation (www.iosco.org)*
✓ *ESMA: various papers to be announced previous to class (www.esma.europa.eu)*

SESSION 4:

4.1: NTERNATIONAL AND MULTI-LATERAL ORGANISATIONS IN FINANCIAL MARKETS AND BANKING REGULATION

- Basel Committee on Banking Supervision
- IOSCO
- Financial Stability Board
- European Securities and Markets Authority (ESMA)
- European Systemic Risk Board (ESRB)
- European Banking Authority (EBA)
- The institutions and their influence in the financial systems and the member countries
- MIFID, EMIR, UCITS, and other basic regulations

✓ *IOSCO: (www.iosco.org)*
✓ *ESMA: (www.esma.europa.eu)*
✓ *Basel Committee on Banking Supervision (www.bis.org)*
✓ *European Banking Authority (www.eba.europa.eu)*
✓ *Financial Stability Board (www.fsb.org)*
✓ *other*

4.2: THE WORLD FINANCIAL CRISIS OF 2OO7 AND ONWARDS

- Discussion about the regulatory and supervisory causes of the crisis.
- Impact on the financial system and the macroeconomic effects
- Regulatory response
- The new environment of the world financial system

- Is the financial world safer after the crisis?

- ✓ *Selected readings of The Financial Times and The Economist of the time*
- ✓ *Martin Hellwig: Capital regulation after the crisis: Business as usual. 2010. Max Planck Institute*
- ✓ *Rym Ayadi: On Basel Regulation and banks Incentives, 2012. New Paradigms in Banking, Financial Markets and Regulation?, SUERF - The European Money and Finance Forum*
- ✓ *Other readings advised prior to class*
- ✓

SESSION 5:

5.1: THE SCANDAL OF THE MANIPULATION OF INTEREST RATES (LIBOR AND EURIBOR)

- The importance of interest rates and other benchmarks as indicators and prices resulting from market forces
- Calculation of Euribor and LIBOR.
- Economic damage from interest rate manipulation
- Deficiencies in EURIBOR and LIBOR calculations
- Incentive to manipulate
- Methods of manipulation
- Detection and enforcement
- Case study of an actual manipulation investigation

- ✓ *Selected readings from financial media from the time of manipulation*
- ✓ *IOSCO: (www.iosco.org): Principles for Financial Benchmarks*
- ✓ *ESMA: (www.esma.europa.eu): Principles for Benchmark setting processes in the EU*
- ✓ *ICE LIBOR: Calculating ICE LIBOR https://www.theice.com/iba/**libor***

5.2: THE CREDIT RATINGS AGENCIES AND THE FINANCIAL CRISIS: REGULATORY ISSUES

Presentation of the CRAs methods for rating conventional issues and structured debt products
The structure of Credit Rating Agencies and their business model: Is there a built-in element for conflict of interest and subsequent adverse effects on markets?

Free discussion

- ✓ *IOSCO: Credit Rating Agencies Internal controls designed to ensure the Integrity of the credit rating process and procedures to manage conflicts of interest. 2012. (www.iosco.org)*
- ✓ *ESMA: Credit Ratings Agencies: Sovereign ratings investigation, 2013(www.esma.europa.eu)*

- ✓ *J. Wolfson, C. Crawford: Lessons from the current financial crisis: Should Credit Rating Agencies be re-structured?. 2010. Journal of Business and Economics research*
- ✓ *Other selected readings from Financial Press from the time of the crisis*

5- BIBLIOGRAPHY

As indicated at the end of each Chapter. Additionally, attached there is a reading list covering in more detail or depth some of the issues covered in class. At each class the professor will give indications as to the usefulness of the pertinent readings. Specific relevant readings and web links will be provided on an ongoing basis during the course. Students are expected to be aware of major financial and economic news and developments by reading the Financial Times and the economy and financial sections of the weekly The Economist.

READING LIST (non-exhaustive)

- Mishkin, F (2012): The Economics of Money, Banking and Financial Markets. Pearson. Global edition.
- Baldwin, R; Cave, M; Lodge, M (2012): Understanding Regulation. Theory, Strategy and Practice. Oxford University Press, second edition.
- Diamond, D and Dybvig, P (1983): Bank Runs, Deposit Insurance and Liquidity. Journal of political Economy, 91
- Bhattacharya,S, Boot, A and Thakor,A (1998): The Economics of Bank Regulation. Journal of Money, Credit and Banking, 30.
- Stiglitz, J.E and Weiss, A (1981): Credit Rationing in Markets with Imperfect Information. American Economic Review.
- Heremans, D, Pacces, A (2011): Regulation of Banking and Financial Markets. ENCYCLOPEDIA OF LAW AND ECONOMICS: REGULATION AND ECONOMICS, 2nd Edition, Rotterdam Institute of Law and Economics (RILE)
- Heremans, D (1999): Regulation of Banking and Financial Markets. ENCYCLOPEDIA OF LAW AND ECONOMICS
- Hellwig, Martin (2012): Capital regulation after the Crisis: Business as usual?. Max Planck Institute
- Zingales, L (2009): The Future of Securities Regulation. Journal mof Accounting Research, 47.
- International Monetary Fund: Lessons of the financial crisis for future regulation of financial institutions and markets and for liquidity management. Monetary and capital markets department, February 2009.
- International Monetary fund: The Challenge of enforcement in securities markets. Mission Impossible? (Ana Carvajal and

Jennifer Elliott). August 2009.
- Christensen HB, Hail L, Leuz C (December 2010): Capital market effects of securities regulation: The role of implementation and enforcement
- Sherman, M (2009): A short history of financial deregulation in the United States. CEPR.
- Dodd, R (2002): The economic rationale for financial market regulation. Financial Policy Forum, Derivatives Study center, Washington D.C. Special policy report 12
- Zingales, L (2004): The costs and benefits of financial market regulation. European Corporate governance Institute, W.P. 21/2004
- New Paradigms in Banking, Financial Markets and Regulation? Edited by Morten
- Balling, Frank Lierman, Freddy van den Spiegel, et al. The European Money and Finance Forum, Vienna 2012.
- Spong, K (2000): Banking Regulation, Its purposes, implementation and effects. Federal Reserve Bank of Kansas City.
- Armour J, Mayer C, Polo A (2011): Regulatory sanctions and reputational damage in financial markets
- Basel Committee on Banking Supervision: www.bis.org/bcbs
- IOSCO: www.iosco.org
- Financial Stability Board: www.financialstabilityboard.org