12M015

Regulation in Financial Markets

Winter Term - 3 ECTS

Elective Course

Prof. Eudald Canadell

Prerequisites to enroll

None

Overview and objectives

This course will focus on the economic principles underlying the regulation and supervision of the financial sector and its evolution over time, and on the interrelations between macroeconomic policy and financial stability from the regulatory perspective. It will analyze, in particular, those elements of financial markets supervision 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 the organization of human life and relationships.

We will review the different pillars of financial sector regulation: prudential, conduct of business rules, markets infra-structure, corporate governance, and financial stability, and their different translation into the regulation and supervision of different pieces of the financial markets structure, namely banking, securities and financial products, derivatives and equity markets.

Financial Stability and Macroeconomic Policy stand nowadays in the core of the work and concerns of regulators, supervisors and politicians around the world, including all the major multilateral international organizations. The Covid – 19 pandemic and the fiscal and monetary measures undertaken by the authorities, with their obvious impact on the soundness of financial institutions and subsequent effects on systemic risk and financial stability, has greatly emphasized this trend which, in any case, was already under way before the crisis. Thus, we will devote considerable amount of time in this course to the associated issues which, in turn, permeate most of the parts of this syllabus

Financial regulation (globally or partially) arouses significant criticism amongst the industry, interest groups and, last, but not least, academia. We will, thus, address some of these criticisms and, in particular, will examine to what extent the benefits of regulation are larger than the costs inflicted by it to participants. We will do this by means of examining costs and benefits of particularly relevant pieces of current regulation

We will address also, time permitting, some current topics, challenges and new developments in regulation which have captured the public eye in the recent years due to the social impact of the issues underlying them: regulation of rating agencies and potential pro-cyclical effects of their work, benchmarks (in particular interest rates), impact of some financial products designed to mitigate risk (in particular default risk), alternative payment systems (stable money), and the relationships and interferences between the economic and political sphere and the degree of control of financial activity, among others.

Course Syllabus

1. **Principles, history and goals of financial regulation**

a. Economic foundations of regulation

Economic foundations of regulation and, in particular, financial 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

b. The overarching goals of financial regulation

- Efficiency in market organization (competition policy)
- 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 (micro-prudential supervision applied to individual financial entities)
- Monitoring the stability of the financial system (macro-prudential supervision applied to the so-called “systemic entities”, markets, trading platforms and payment systems, etc.)
- Integrity and safety of the trading and post-trading infra-structures
- Money policy and macroeconomic stability.

2. **Banking regulation (micro perspective)**

Solvency and liquidity of credit institutions as the main concern of financial authorities, directed to avoid or minimize the occurrence of bank runs and other situations that might de-stabilize the financial system and the economy at large

- Protective measures (Deposit guarantee, Lender of last resort, other)
- Preventive measures (mostly Prudential regulation)
- 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
    a. Regulatory capital for credit risk, market risk, operational risk, reputational risk and others.
    b. Liquidity and leverage ratios
    c. Asset eligibility in computing regulatory capital
    d. Bank equity as a guarantee of prudency. Requirements on the ratio debt/equity to control banks’ risk.

Basel capital agreements: from the minimum capital standards to face credit risk (Basel I) to a general and overarching framework of prudential regulation for the overall banking system (Basel III)

3. Securities markets regulation (micro perspective)

In comparison to the banking model and its regulation, the key to the appropriate performance of securities markets and their regulation lies on the availability of complete and verifiable information (disclosure), the transparency in the operations and the strict observance of the conduct of business rules amongst market agents and between them and their clients.

- Primary markets
  a. Regulation of information contained in prospectuses, accounting standards, relevant information, shareholding, etc.
  b. Debt issues and complex products. Examples (CDS, structured products, swaps, complex derivatives, …)
  c. Credit rating agencies regulation
  d. Regulations applicable to managers and administrators of publicly listed companies, corporate governance

- Secondary markets
  a. Regulation of systems and trading mechanisms, exchanges, derivatives exchanges, multilateral trading matching systems, etc.. Self-regulation
  b. Prevention and detection of market abuse and price manipulation. Insider trading
  c. Market infra-structure regulation
- Investment Services Firms
  a. Regulation of conduct with the clients and in the markets
  b. Review of practices designed to alter the orderly functioning of markets
  c. Prudential measures applied to financial intermediaries, segregation of clients assets
  d. “know your client” rules, assessment of suitability and convenience of investments offered to clients, fair treatment, disclosure of information provided to clients, advisory services, …

4. Financial Stability and Macroprudential Policy

Context and relevance of financial stability and macroprudential policy:

- Concept of financial stability
- Macroprudential policy
- Examples of crisis related to systemic risk (The great financial crisis of 2007-2008 and the COVID-19 pandemic)

Central banks in the origin of the tasks to identify and follow systemic crisis

- Entity size: key to systemic risk
- Macroprudential tools: capital requirements, countercyclical provisions, LTV limits etc

The financial crisis changes perception of systemic risk and broadens the spectrum of regulators and supervisors to play a relevant role

- Sources of systemic risk: interconnectedness, substitution degree, concentration, lack of transparency, hedging, complexity,
- The role of confidence
- New definitions of financial stability
- New principles of IOSCO
- Non-Bank Financial intermediation (Previously designated as "*shadow banking*")
- Money market funds and fixed income funds
- Financial intermediaries
- Securitizations

5. Macroeconomics and macroprudential policy in action

- The interactions of Macroeconomic shocks, macroeconomic policy (support fiscal and monetary measures, inflation goals, interest rate and money facilities) and Financial stability,
- The interactions between regulatory policy and macroprudential tools and financial stability and its direct effects on macroeconomic stability
- The use of microprudential policies for macroprudential goals
- Financial stability at the international level

- FSB
- ESRB
- IOSCO / ESMA
- Architecture of macroprudential policy in particular countries or jurisdictions

6. Discussion on specific topics on market and banking regulation

- Corporate governance for banks and listed companies. Remuneration, incentives, corporate responsibility, sustainability.
- Regulation of Credit Rating Agencies and their interaction with market performance, investor protection and corporate responsibility, recent challenges related interest rates, indices and other benchmarks in international markets.

Required Activities

Attendance and active participation in the class discussions. Students will also be asked to develop a brief case of a practical application of financial regulation in groups (maximum 4 persons per group), which will be presented and discussed in class.

Evaluation

Evaluation will be based on a final exam covering the topics developed in class as well as performance and discussion of the case study presented by groups.

Competences

☐ To (be able to) communicate with determination and in the English Language, the results and implications of the required analytical study using a language that the receiver can relate to.

☐ To work within a heterogeneous team of researchers as economic analyst using specific group techniques.

☐ To fit in diverse professional environments and varied types of collaborations in different professional projects.

☐ To possess and understand the knowledge that provides a basis or opportunity to be original in the development and / or application of ideas, often in a research context.

☐ That the students be able to integrate knowledge and face the complexity of making judgments based on information that, being incomplete or limited, include reflections on the social and ethical responsibilities linked to the application of their knowledge and judgments.

☐ That the students be able to communicate their conclusions and the knowledge and the ultimate reasons that sustain them to both, specialized and non-specialized publics in a clear and unambiguous way.

☐ That students possess the learning skills that allow them to continue studying in a way that will be largely self-directed or autonomous.

☐ To identify and apply the insights of the theory, the models, and the analytical tools of modern economy to its global dimension.

☐ Understand and apply the economic theory of macroeconomic models and financial markets.

Learning outcomes

☐ Applies econometric techniques for an applied analysis of financial market policies.

☐ Empirically characterizes relevant phenomena from the macroeconomic point of view.

Reading list

- Armour, Awrey, Davies et al: Principles of Financial Regulation. Oxford University Press 2016. (selected chapters TBA)
- 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
- Dirk Heremans, Alessio Paces: Regulation of Banking and Financial Markets. April 2011, Rotterdam Institute of Law and Economics
- 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
- 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)
- ICE LIBOR: Calculating ICE LIBOR. https://www.theice.com/iba/libor
- Roger Myerson: Rethinking the principles of bank regulations: A review of Admati and Hellwig banker new clothes”.
- The role of credit rating agencies in structured finance markets. OICV-IOSCO, Final Report, May 2008
- IMF-BIS-FBS (2009): “Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations”. International Monetary Fund, Bank for International Settlements and Financial Stability Board.

- European Central Bank (2011). “Special Feature C: Systemic risk methodologies”, Financial Stability Review, June, pp. 141-148.
- D. K. Patro, M. Qi, and X. Sun. A simple indicator of systemic risk. Journal of Financial Stability, 9(1), 2013.
- Macroprudential policy beyond banking: an ESRB strategy paper July 2016. ESRB
- ECB. The concept of systemic risk. Technical report, European Central Bank Financial Stability Review, 12 2009.
- IOSCO (2011). “Mitigating Systemic Risk A Role for Securities Regulators”. Discussion paper or01/11.
- ECB. New quantitative measures of systemic risk. Technical report, Financial Stability Review, 12 2010
- J. C. Trichet. Clare distinguished lecture in economics and public policy, 2009. Speech at University of Cambridge organised by the Clare College.
- P. Calluzzo and G. N. Dong. Has the financial system become safer after the crisis? The changing nature of

Selected papers TBA from:

- ✓ IOSCO: (www.iosco.org)
- ✓ ESMA: (www.esma.europa.eu)
- ✓ ESRB (https://www.esrb.europa.eu/home)
- ✓ Basel Committee on Banking Supervision (www.bis.org)
- ✓ European Banking Authority (www.eba.europa.eu)
- ✓ Financial Stability Board (www.fsb.org)

- Other papers and journal articles to be referred to as appropriate depending on the class discussions

More recent documentation, in particular, that from ESRB, ECB. US FED, IOSCO and BIS, related to macroprudential tools and macroeconomic measures, to be updated and provided closer to the course inception