

Financial regulation in the uk and ireland finance essay

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There has been considerable changes in the regulation of financial markets in the UK and other countries. Why is this? Financial markets tend to be more highly regulated than other markets. Explain why. In May 1997, the British Chancellor of the Exchequer made the decision to move the responsibility of supervision of financial institutions into the hands of a new regulatory authority, the Financial Services Authority (FSA). This new authority replaced the Securities and Investments Board and took over responsibility for the supervision of banks, listed money market institutions and clearing houses from the Bank of England. (Blake, 1999). Overall responsibility for regulation of financial markets lies with HM Treasury and is then divided up between the Bank of England and the FSA. Now, the Bank of England's remit is the operation of monetary policy and ensuring the stability of the financial system. The FSA has five primary functions: Authorisation of market participants; Prudential supervision of banks, insurance companies, securities firms and fund managers, and regulation of their conduct of business; Investigation, enforcement and discipline; Regulation of investment exchanges and clearing houses; Regulation of collective investment schemes. The change has been a move away from largely self-regulation to a combination of self-regulation and government interventionist regulation. Before 1997 the UK relied ' primarily on private regulation (by the stock exchange and, to an increasing extent, by the institutes of chartered accountants).' (Benston, 1985). The regulation of the financial system in the UK however is not as explicit as the system in the US where the Securities and Exchange Commission holds some of the most extensive regulations, which are viewed by some as being excessive." The more complex and

formal US rules and procedures do not permit as much flexibility and speed" (Benston, 1995). So the UK's new system is a compromise between the best of self regulation and statutory regulation to ensure the financial markets work in an efficient and orderly manner. The FSA reinforces the orderly operation of the UK markets. For example, when a firm wishes to list on the London Stock Exchange (LSE), they must satisfy requirements of the previously self-regulatory LSE as well as the United Kingdom Listing Authority (UKLA), which is a body of the FSA. Both authorities work closely together and have powers of instituting disclosure requirements, compliance of provisions and enforcement of standards. (LSE, 2000). The regulation of financial markets is changing continually all over the world. In Europe, membership of the EU has changed the priorities of Governments when facing the problems of changing or implementing regulation of the financial system, " One of the main issues confronting the regulation of markets and financial institutions is cooperation from other jurisdictions." Quinn's 1992 article asserts that the harmonisation of banking rules in the EU, the co-ordination of countries own regulatory standards and centralisation of an EU integrated financial market are needed to enable swift reaction to any future market failure. (Quinn, 1992). Standards differ greatly across countries. Ireland's Central Bank is the primary regulator of financial markets. In the UK, the newly established FSA has taken over the reins from the Bank of England and in Denmark, a separate regulatory authority also exists, (Stewart, 1995). The differences are not solely institutional, there are also huge variations in the powers of these differing institutions. In Ireland the system is viewed as: " far too fragmentary to be effective" (Stewart, 1995).

Any powers of investigation and enforcement are unclear and appear ineffective. In Germany, a financial regulator also exists. The effectiveness of their regulation has recently been questioned. The Neuer Markt, the three year old market for growth stocks had just announced new rules which aim to improve the flow of company information to investors. It is hoped that these new rules will restore investors' confidence in a market damaged by profit warnings, insider dealing investigations and insolvencies. The article argues that the rules are long overdue." They still do not afford investors the transparency found in the UK, with its more established equity culture", (Financial Times, 2001). Stewart's suggestion of ' an umbrella grouping, under an appropriate directive, at EU level which will collate information and provide expertise on legislative detail in different countries" (Stewart, 1995), seems a desperately needed measure to bring the differences across the EU a little closer together. While Europe struggles with coordination difficulties, the question of whether statutory government regulation is beneficial to financial markets is constantly debated. The frequently stated case for government regulation is based on the fact that failures in the market do occur and the interests of the public, therefore must be protected. Protection of Public interest is fundamental due to inherent difficulties within the financial services industry such as informational asymmetries which result in market failures. Due attention needs to be paid to banks when evaluating regulation of financial markets as they form such an important part of the financial services sector." Bank failures around the world in recent years have been common, large and expensive" (Goodhart et al., 1998). Banks provide three primary services. The ' efficient payments system and the

management of asset portfolios' ((Fama), Quinn, 1992) and also ' risk sharing and the monitoring and screening of borrowers' ((Balkensperger & Dermine) Quinn, 1992). The primary source of market failure comes from the monitoring and risk sharing. A bank has two types of risk sharing functions. They should have a well-diversified portfolio of assets which would provide fixed returns over a time period to a depositor's investment. They should also maintain an element of liquidity, so that if depositor wishes to liquidate his assets it can be done so on demand. The existence of these two functions means that a mismatch of assets and liabilities exists within the bank. It is widely documented that risk sharing contracts make banks very susceptible to ' runs'. " the solvency of one bank may be affected by the failure of another bank because of loss of confidence and large-scale withdrawals" usually as a result of " a mismatch between the date to maturity of assets and liabilities" (Stewart, 1996). These bank runs can have a drastic effect on the public as banks are where the vast majority of people carry out their financial transactions such as savings and mortgages. The public tends to have an inherent trust in the banks and therefore depositors have a reduced capacity for evaluating and monitoring their banks. Banks will not impose strict self-regulations unnecessarily. The danger of this situation is that banks might not provide services efficiently and therefore drag down the quality level of services in the industry. The need for public protection against these bank runs gives rise to the need for intervention to provide this protection: The " State guarantees to depositors and guarantees by central banks to act as lender of last resort may prevent sudden losses." (Stewart, 1996). Those who are against government intervention argue that it should

be possible for banks to attain all levels of financing at any time in an efficient market, and that the existence of emergency financing will only ensure that banks will be negligent about their risk levels since they can rely on the central bank to aid any crises. In fact, banks hold forms of illiquid debt financing, so if a 'run' were to occur, it would not be possible to liquidate this debt. It has also been suggested that the real effects of a banking collapse are felt in the macro-economy. Quinn suggests that the banking collapse of the 1930s has severe effects on the 'depth and duration of the Great Depression which followed' (Quinn, 1992). Combined with the lack of motivation on depositors' behalf to monitor and screen banks, there is a clear case for government intervention. The other primary reason for market failure in the banking system lies in the provision and screening services that they provide to offset informational problems. The relationship which requires the most attention is that between the depositor and the bank. A depositor cannot distinguish between a bank that has a high risk strategy or has a low risk strategy and since deposit rates must reflect average risk then a bank which follows a high risk strategy is hidden. The misallocation of resources which ensues may lead people to believe that individual deposit rates should be applied to each different bank reflecting their riskiness. In fact, "such differential deposit rates will be undermined by the public good nature of the evaluation and monitoring of banks" (Quinn, 1992). A very strong argument exists against Government intervention. In most of the other industries in our economy, there is quite a lot of transparency for consumers regarding how risky it is to buy goods and services and therefore, would it not be better to allow the public to deal with the informational

asymmetries inherent in the banking system. One particular response to this problem of unidentifiable risk has been to impose flexible capital adequacy ratios. (Bank of International Settlements (BIS) and EU)." increasing the ratio of own capital to total capital as a means of ensuring bank solvency"

(Stewart, 1996). This ratio has three different effects. (1) Since the capital asset ratio has been reduced, banks take on less risk; (2) It ensures that banks who take on higher levels of risk must have a higher proportion of their own capital in reserve; (3) Since it is difficult to establish whether higher ratios really represent a risky portfolio, banks will cooperate.

However, the establishment of these ratios has caused problems for banks and regulators. Banks are required to both define and measure capital and income. Since income is turned into capital on the balance sheet, there has been much emphasis placed on the measurement of income by the regulators. Another issue which needs attention is who should measure capital and income. Is internal auditing sufficient or is there a need for an independent, external auditor. The most vital issue, however is on which country's accounting standards should the ratios be based on. Stewart illustrates this in his article using the US and UK Generally Accepted Accounting Practices to calculate different figures for capital and income. This emphasises the need, expressed earlier, for harmonisation at an EU level. What about non banking financial firms? It is needed here to assess the level of risk taken on between companies. In general, it is not possible to quantify and correlate financial risk across all firms operating in the industry. So this means that systematic risk of failure in non-bank firms is much lower than in banking. Benston argues strongly against regulation in financial

markets, concentrating heavily on statutory disclosure of information of firms quoted on the US exchanges. " The weight of the arguments and data strongly supports the conclusion that the costs of government-required disclosure exceed any possible benefits" (Benston, 1985. He asserts that the pre 1997 UK way of self regulation is superior to the strict rules of the SEC in the US. The question of whether interventionist statutory legislation is useful is being constantly discussed. Perhaps the UK have got it right now with a combination self-regulation and statutory regulation. There will perhaps be change in the US over the next few years with the advent of a new president who will appoint a new chairman of the SEC in the near future when Arthur Levitt steps down. ' In addition, as many as three of the five top-level commissioner positions at the SEC are either vacant or will be vacant in the coming year, positions that to a great extent shape SEC policymaking with the chairman' (Financial Times, 2000). Change may also come from Phil Gramm the US senator and head of the Senate banking committee, who has ordered a review of US securities law. Mr. Gramm is a well-known regulation opponent in the US. Change is without a doubt imminent. The most important concern is to keep markets orderly and transparent. For some countries it has come in the form of strict regulation, for others in relatively flexible regulation. The challenges now come from the increasing need for harmonisation of regulations in the EU and also the need to react to the effect that technology can have on financial markets, something that many current financial regulatory systems have yet to tackle.