Regulations of financial markets and global financial crisis

Economics, Financial Markets

Since the inception of this world, people are following rules in one way or the other. Every aspect of our lives follows a pattern. The best patterns and practices are developed in to rules. If there are no rules, there will be chaos everywhere and catastrophe ready to strike at any moment. To keep our lives peaceful and in order, we follow rules. Some of them are set by us and some by law experts and regulators. Regulation is setting up of rules (Gowland, 1990). Regulations are imposed for our own protection. In the business and financial world, regulations play a vital role in the structuring of the system.

Without regulations, the businesses and economies would fail. The financial world's main reason for existence is to deal withmoney. Financial world comprise of stock markets, banks, insurance companies etc. The financial markets control the money in every aspect possible. This is the reason regulating the financial markets is necessary. Aims of Regulation: Regulating the financial markets and institutions comes at a cost. It is quite expensive to develop and implement the regulations (Gowland, 1990). The regulatory bodies need to have a very strong reason to regulate the financial markets and institutions.

The main reasons of the regulation of financial markets and institutions includes; the association of financial markets with investor's money (Pilbeam, 1998). People all over the world invest money in different ways; they can invest in the stock markets, in banks or in insurance companies. To protect the investor's money, regulations are imposed. If the financial markets and institutions are not regulated, people can lose their money all of

a sudden. To prevent sudden losses and reduce the risk of losing money, financial markets and institutions are regulated.

Another reason for regulating the financial markets and institutions is that they are major employers in the businesses and economic world (Howells and Bain, 2004). Financial institutions all over the world employee hundreds of thousands of people, thus plays a major role as an employer. In order to protect the employees and their jobs and to stabilise its operations, the financial institutions are regulated. Financial institutions operate multi nationally, diversifying its operations across the globe. Financial markets and institutions can be considered as a significant foreign exchange earner of the country (Howells and Bain, 2004).

In order to protect the economy of the country, these financial institution and markets are regulated. Financial world is now regulated for centuries now. The facts that triggered regulation were financial crisis and market failures (Pilbeam, 1998). The first set of financial regulation was implemented after the crisis of TULIPMANIA in 1637 (Howells and Bain, 2004). TULIPMANIA (1637) was the first major crisis that hit the financial world and that triggered the inception of the regulation of financial markets and institutions (Howells and Bain, 2004).

Thus regulations are implemented to prevent the financial institutions from failing. Regulation implemented help to keep the financial world stable and its operations in check. Another reason of regulation is to provide protection to investors against fraud and mismanagement (Pilbeam, 1998). Regulators make every effort to prevent fraud and take most severe action against

those who commit fraud. Regulators strive to ensure fair competition and pricing for consumers, hence protecting consumer rights by regulations (Pilbeam, 1998).

In the absence of regulations, financial institutions can increase the prices of financial products and services, creating an imbalance in the financial markets. Thus to ensure fair competition and to keep the prices under control, financial markets and institutions are regulated. Financial markets and institutions help to shape the corporate and financial structure of the country. Therefore to keep the economy of the country stable, regulations are implemented. Regulations ensure fair disclosure of information to all the entities involved in a financial transaction (Pilbeam, 1998).

Without regulations, one entity can have more information and it can take illicit advantage from that information. To ensure fair dealing and to prevent other entities from exposure to risk, regulations are imposed which ensure that all necessary information is disclosed prior to the transaction taking place. Market Failures and Crisis: Regulations of financial institutions have always followed financial crisis and failures. Market failures and crisis are the primary triggers of that lead to the development of regulations of financial markets and institutions (Howells and Bain, 2004).

Although regulations cannot completely prevent the markets fromfailure, they can reduce the risk (Pilbeam, 1998). Causes of Market Failures and Crisis: The failure and crisis in the financial markets and institutions can be caused by many factors. One can be inefficient allocation of resources (Pilbeam, 1998). Every operation of financial institutions includes monetary

transactions. Whenever there is a shortage of money; crisis start. Therefore for all the operations of financial markets and institutions sufficient monetary funds are allocated for its smooth operation.

Markets also fail when there is monopoly and imbalance of power in financial institutions (Pilbeam, 1998). It occurs when people take unlawful advantage of their power and position in the financial institutions. It can be beneficial for them as an individual but it can eventually lead the financial institution in to crisis. Another cause of market failure can be information asymmetry. It occurs when one party has more or better information than the other (Howells and Bain, 2004). This creates an imbalance of power in the transactions which can sometimes cause the transactions to go awry.

Examples of this problem are; Adverse Selection and Moral Hazard. In case of adverse selection, the party displays immoral behaviour by taking advantage of the asymmetric information prior to the transaction (Howells and Bain, 2004). For example, some people secure life insurance, although aware of their deterioratinghealthconditions. Moral hazard occurs when a party insulated from risk behaves differently than it would have if it were fully exposed to the risk (Howells and Bain, 2004). For example, people with automobile or mobile phone insurance will use their automobiles or mobile phones with lesser care than if uninsured.

All these events cause a loss of confidence in the financial markets and institutions and lead them into crisis and cause failures. A very famous example of market failure is known as Black Monday. It occurred on 19th October, 1987, when financial markets all over the world crashed and many

financial institutions went into bankruptcy. Therefore, in order to prevent financial markets and institutions from crashing, to protect investor's money, to prevent fraud and mismanagement and to enhance the disclosure of information all the entities involved in financial transactions, financial markets and institutions are regulated.

Regulations in Practice: Financial markets and institutions are regulated by regulatory authorities under the control and influence of government. Here are a few types of regulations that are implemented and practiced in the financial markets and institutions all over the world. * Structural Regulations monitor the types of activities, products and geographical boundaries in which a financial institution can operate (Pilbeam, 1998). * Prudential Regulations monitors the internal management of a financial institution (Pilbeam, 1998).

For example, the setting of ratios to ensure that the institution has sufficient capital to absorb possible losses and sufficient liquidity to ensure it can meet its obligations * Investor Protection: This covers the measures designed to protect investors from mismanagement, malpractice and fraud (Pilbeam, 1998). * Licensing Regulations: When a financial institution is formed, it is required to attain a license from regulatory authority. That license binds the institution into a contract that makes it obligatory to follow the regulations devised by the authorities (Pilbeam, 1998).

* Disclosure Requirements: Regulatory framework requires the financial institution to disclose large amounts of information related to their financial performance to potential investors (Pilbeam, 1998). This reduces the risk of

information asymmetry. * Deposit Insurance: This scheme guarantee the security of investor money in case of failure of the financial institution. But this gives rise to moral hazard, as investors carelessly invest more money in financial institutions which give higher interest. And in order to pay such interest, the financial institution may invest funds in high risk ventures and may become insolvent.

As stated by Pilbeam (1998) ‘ Insuring against an event makes that event more likely to occur’. * Restriction on Activities: This is further developed under structural regulations. It restricts the activities that can be undertaken by financial institutions. For example, in the United Kingdom, until the mid-1980’s the building societies were limited to mortgage lending only (Pilbeam, 1998). * Exposure Limits: This controls the risk of exposure of financial institutions. For example, most regulatory authorities expect the banks to have a diversified asset portfolio to control its risk exposure.

In United Kingdom, a bank is required to notify The Bank of England if its exposure to any individual client is greater than 10% of its capital base. And exposure above 25% requires official permission of The Bank of England prior to the exposure (Pilbeam, 1998). Since exchange rates can move rapidly, banks are restricted to a maximum exposure of 10% of its capital base for any individual currency and a maximum of 15% for all the currencies (Pilbeam, 1998). * Liquidity Requirements: Financial Institutions like banks have liquid liabilities (deposits) and relatively illiquid assets (loans) (Pilbeam, 1998).

Regulations aim to ensure that unnecessary problems do not arise due to insufficient liquidity to meet depositors' demands. Therefore banks are expected and sometimes legally required to keep enough cash reserves to meet the withdrawal demands of the depositors (Pilbeam, 1998). Banks and Regulations: Banks are most severely regulated financial institutions because most significant financial crisis has been associated with banks. For example, in the United States, during the period of 1924-1934, 11000 banks collapsed due to regulatory crisis (Pilbeam, 1998). Self-Regulation:

These regulations are implemented in the financial institutions by financial practitioners who are part of the institution for its stable operation (Howells and Bain, 2004). It is claimed that the financial practitioners and experts who are running the financial institutions are better judges of rules that need implementation. That is why self-regulation is carried out. They considered the statutory regulations as time consuming and expensive, as compliance cost is quite high for regulations devised by regulatory authorities (Howells and Bain, 2004). Advantages of Self-Regulation:

They are considered to be more flexible as compared to the statutory regulations. They quickly adapt to the change in the financial institutions (Pilbeam, 1998). They can be more effective as they are made by financial practitioners who are part of the financial institutions. They can help to root out fraud and mismanagement more quickly (Pilbeam, 1998). Disadvantages of Self-Regulation: They can be biased to favour the financial institutions rather than the consumers. A completely informal self-regulatory framework

can only work in small financial institutions internally (Howells and Bain, 2004).

In United Kingdom, in the Financial Services Act of 1986, self-regulation was encouraged, but in the Reforms of 1998, the self-regulatory system for the city of London was abandoned and full statutory regulations were re-established (Pilbeam, 1998). International Financial Regulation: It was argued by many regulators and financial practitioners that to improve global operations of the financial institutions, financial institutions all over the world must be subject to the same regulations (Morrison and White, 2009).

But when this matter was looked in to practically; it was dropped stating that it was too costly to standardise the regulatory framework internationally. It was further stated that even the country with strong financial structure will have to follow the regulations that are needed only by the countries with weak financial structures (Morrison and White, 2009). De-Regulation: De-regulation should really be called re-regulation, as it is not scrapping of regulations; it is the replacement of one set of regulations with an improved set of regulations (Howells and Bain, 2004).

Regulation is a continuous process and the reasons that lead up to de-regulation include; Globalisation: De-regulation occurs as financial institutions are operating in a highly globalisedenvironment, because there is a tremendous increase in cross border transactions. Another cause of de-regulation is multinational financial institutions; as financial institutions with operate in more than one country need to cover the regulations implemented in both the countries (Howells and Bain, 2004).

Innovation: Changes in the regulatory framework are also required when new financial products and instruments are developed or when changes in the market structure occur (Howells and Bain, 2004). De-regulation also occurs eliminate the weaknesses in the previous regulations that lead up to financial crisis, or events like malpractice and fraud occurred (Pilbeam, 1998). In United Kingdom, London Stock Exchange was losing business and investors to other countries with better regulatory and financial structure (Pilbeam, 1998). That was when the biggest event of de-regulation took place on 27th October, 1986.

It was called Big Bang. Financial Crisis and Regulation: ‘ The financial crisis that broke in August, 2007 exposed numerous fault lines in the regulatory framework’ (Begg, 2009: 1107); it became clear that extensive changes were required in the regulations to bring the financial institutions out of crisis. This need was fully acknowledged by the regulatory authorities (Begg, 2009). A main reason for the crisis can be that the current regulatory framework dates from 1980s. Another fact that might have caused the crisis is the inadequacy of the relationship between regulatory bodies and the central bank (Begg, 2009).

Therefore it was decided to bring numerous changes in the regulatory framework. At the moment many of these changes are already under development. The system that will emerge after the crisis will definitely look different but it is still unsure whether it will address all the shortcomings of the previous system (Begg, 2009). The examples of the recent financial crisis include; Northern Rock, a high street bank, which became an early victim of

financial crisis and collapsed due to liquidity problems in its business model (Begg, 2009).

In the current climate of crisis, large number of mergers and takeovers are going on. The misguided takeover of ABN-AMRO Bank by The Royal Bank of Scotland seemed expensive but potentially lucrative at the time of takeover, but it eventually destroyed The Royal Bank of Scotland (Begg, 2009). Global Financial Crisis (GFC): A commonly held view is that the current GFC had its roots in the United States financial system as GFC is said to have its worst economic impact there. But it has affected the rest of the world quite severely as well.

It was argued that there must be something wrong with the financial structure in US as all the states are regulated by their own independent regulatory authorities (Edgar, 2009). But this argument was dropped as United Kingdom which has a single regulatory body ' Financial Services Authority (FSA) was also suffering from GFC. Some practitioners say that the problems in the UK were caused by the split off of FSA from the Bank of England (Edgar, 2009). Regulators and practitioners argued that Australia was also regulated by a single regulator which was quite similar to FSA, but its performance was much better in the era of GFC (Edgar, 2009).

And these theories and arguments still could not explain the similar economic problems in other European countries which operate under a variety of regulatory structures. It was concluded by the regulators that the financial instability in most countries was concentrated in investment banks or commercial banks with large investment banking operations (Edgar,

2009). It was declared that investment banks were largely outside the financial regulatory control and were able to gear the balance sheets to an extraordinary degree to enhance their financial position (Edgar, 2009).

Investment banks were either unregulated or under regulated, resulting in leverage levels that were far too risky for their business model (Edgar, 2009). In a number of countries, a significant source of instability for commercial banks has been generated by their house financing operations. Credit rating agencies were held responsible for the crisis caused by house financing activities (Edgar, 2009). They encouraged borrowers with insufficient financial means to enter housing credit arrangements that were highly unsustainable in an economic downturn. Conclusion:

Therefore it was concluded that the recent GFC were mainly caused by the investment banks and house financing operations, in which credit rating agencies were also involved. It was mainly because of weaknesses in the regulatory framework that did not covered investment banks and credit rating agencies. Thus it was decided to develop a new set of regulations to bring investment banks, credit rating agencies and house financing operations under control of the regulatory framework to come out of the on-going crisis as a success and for a better economic structure of the financial world.