LECTURE OUTLINES.

1. INTRODUCTION TO FINANCIAL INSTITUTIONS.

0 Introductory
Textbooks and change. Macroeconomic background.

1 Issues addressed in this course

2 Asymmetric Information
Asymmetric Information and 'pooling equilibrium'; Adverse Selection and Akerlof's 'lemons'; Moral Hazard; State Verification. Exogenous and endogenous information.

3 Financial products as contracts
Delegation; ownership; control.

4 Why begin with fund management?
Mutual fund management as 'pure' delegation, with extreme asymmetry of information.

5 Structure of the course

2. INTRODUCTION TO FINANCIAL REGULATION.

1 Market failure and the rationale for regulation: the underlying market theory
Pareto optimality; the 'complete market'; market failure and the rationale for regulation.

2 Can solutions to market failure be generated from within the market itself?
Reputation; 'signalling equilibrium'; intermediation.

3 Collective action by the industry to counter market failure
Minimum standards rules; mutual monitoring; mutual industrial insurance.

4 Market failure and government intervention
Limitations of self-regulation: legal; 'regulatory capture'.

5 Financial regulation: historical experience – *preview*
Scandals of the 1990s; trend to more unitary approach; international dimension.

6 Coursework project

3. THE INSURANCE MARKET AND ITS REGULATION.

1 Mutual insurance

Pareto-optimality and the full information assumption; idiosyncratic and common risk; mutual insurance schemes past and present.

2 Features which insurance *shares* with other retail financial services

3 Features which *distinguish* insurance from other retail financial services

Two-way informational asymmetry. 'Separating equilibrium'.

4 The problem of under-insurance

Low income effectively acts as limited liability; moral obligations to provide essential services; common risk and political lobbying-power; banks: the problem of 'too big to fail'.

5 Compulsory full insurance and its limitations

The problem of market capture; compulsion and moral hazard; compulsion and monitoring; state insurance and disincentive effects

6 Limited liability and prudential regulation

Asymmetric gearing and excessive risk-taking. Prudential regulation in insurance and banking

4. CAPITAL MARKETS.

1 Capital markets

Functions, distinctive features, information structure.

2 Preview of capital market microeconomics.

(a) Information asymmetric and exogenous: First case: Single trading day. (b) Information asymmetric and exogenous: Second case: Revelation of information. (c) Information asymmetric and *endogenous*. (d) True value affected by share price.

3 Primary capital markets and their regulation

Issue mechanisms; information structure

4 Secondary capital markets: functions and information structure

Liquidity; 'immediacy'; role in disseminating information

5 Two extreme situations in the secondary capital market

Thick/homogenous/rapid, and thin/heterogeneous/slow

6 Dealership systems

Quote-driven and order-driven; liquidity demand and dealers as 'market-makers'.

5. CAPITAL MARKET MICROSTRUCTURE

I. Information revelation. (=S5)

- **1 Price dynamics with gradual revelation of insider information**
- **2 Market efficiency and the informativeness of prices**
- **3 Insider regulation**
  The trade-off facing the regulator.

II. Endogenous information. (=S6)

- **1 Security research: the Grossman-Stiglitz theorem**
- **2 Research and social welfare**
  Is there a 'socially optimal' level of research?
- **3 Issues in secondary market regulation**

III. Management incentives. (=S7)

- **1 Capital markets and managerial efficiency: the Principal-Agent problem**
- **2 Actions by shareholders to solve Principal Agent Problem**
  Monitoring; intermediation; incentive contracts.
- **3 'Takeover discipline': a market solution to the Principal-Agent problem?**
  Takeovers and management efficiency. Issues in takeover microeconomics.
- **4 Takeovers: the historical experience**

6. INTERMEDIATION.

1 Summary of shortcomings of stock markets.

2 Intermediation theory (1) Bank confidentiality and the signalling role of bank lending

Bank becomes insider; effects of announcement of loan; mutual benefits; 'equity cushion'; limitations of the theory.

3 Intermediation theory (2) Delegated monitoring

Design of incentive loan contracts. Penalties. Monitoring ('policing') and economies of scale and scope in monitoring. Depositors and double layer of monitoring. Optimal loan and deposit contracts. Limitations of the model.

7. BANKS AND EXCESSIVE RISK-TAKING.

1. Convexity and excessive risk-taking: a principal-agent problem for holders of debt.
Convexity; negative incentive; excessive risk-taking / asset substitution.

2. Creditor protection (a) Creditors of commercial companies.
(i) Public bond issues to commercial companies.
(ii) Bank loans to commercial companies.
(iii) Legal protection for creditors of commercial companies.

3. Creditor protection (b) Protection of bank's depositors.
Gearing.

4. Equilibrium credit rationing.
'Availability'; sticky loan rates; equilibrium credit rationing.

5. Deposit rate as regulation instrument when prudential regulation fails.
Prudential regulation of bank loans. Situations arising when prudential regulations can be circumvented. Loan rate ceiling as 'second best' solution.

8. LIQUIDITY REQUIREMENTS AND SYSTEMIC RISK.

1. Uncertain liquidity requirements.

2. Modelling bank runs.

3. Measures to prevent bank runs.
(i) Suspension of convertibility.
(ii) Government-backed deposit insurance.
(iii) Lender of last resort facility.

9. BANK REGULATION.

Review.
Problems of financial markets without intermediation.
How intermediation may address these problems.
Convexity and excessive risk-taking in banking.
Credit rationing: (a) 'Off equilibrium'; (b) Equilibrium.
Asymmetrical information, systemic risk, and regulation.
Asset transformation.
Costs of liquidation.
Uncertain liquidity demand.

Continued…

Financial institutions and regulation.

Financial contracts: (a) Delegation straightforward; (b) Delegation less clear-cut. Legal, accounting, regulatory systems.

Why banks are so heavily regulated.

Characteristic features of current regimes.

Current regulatory regimes: theory and reality.

10. BANK REGULATION AND FINANCIAL ARCHITECTURE.

Incentives to monitor and their limitations.

Criticisms of current regime: stakeholders absent from agency structure. Suggested alternative and its limitations.

Laissez-faire banking: the free banking era.

Supposed successes of 19th century system: clearing-house system / self regulation. Limited relevance in contemporary circumstances.

Legal systems and financial architecture.

'Anglo-Saxon' tradition (now increasingly global). Continental Europe / Japan tradition.

Responses to macroeconomic turbulence of 1970s/80s:

Financial innovation. Deposit substitutes. Interest on deposits.

Case for a single financial services regulator.

FSA. Convergence between banks and non-bank financial institutions / cross-provision. Systemic risk. Problems of duplication / multiple reporting. Economies of scale and scope.

Problems and issues in 'one-stop' financial regulation.

(1) Problem of intra-firm compartmentalisation.
(2) Legal-disciplinary distinction.
(3) Financial stability and lender of last resort facility remain separate.

Appendix: Core Purposes of the Bank of England.