Yr 13 Economics

Theme 4: A global perspective

Section 4.4: The financial sector

4.4.2 Market failure in the financial sector

- Consideration of:
  - Asymmetric information
  - Externalities
  - Moral hazard
  - Speculation and market bubbles
  - Market rigging

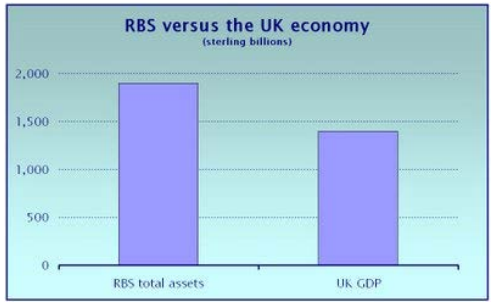
The specification:

- Theme 4 – A global perspective
  - The financial sector

Subject content	What students need to learn:
4.4.2 Market failure in the financial sector	a) Consideration of: o asymmetric information o externalities o moral hazard o speculation and market bubbles o market rigging

“Too big to fail” and moral hazard

The financial crisis of 2007–08 highlighted the danger of a market dominated by a small number of very large banking institutions.



- One of the reasons why RBS and Lloyds received government funding was that they were perceived to be ‘too big to fail’.
  - This is because there would be such a huge impact on the economy if they were to fail that the government was bound to prevent this from happening
    - This is a problem because if big banks think that they will always be rescued, they might behave less cautiously and take more risk. This is known as **moral hazard**.
- A personal example of moral hazard is as follows:
  - Someone who takes out travel insurance, then doesn’t lock their suitcase and leaves it unguarded, in the knowledge that it and its contents are insured anyway.
    - They would probably be more careful if they were to have no insurance
- Moral hazard can also arise in the context of banks
  - If they believe that the government will bail them out in a crisis. This knowledge can make them less careful in assessing the risks that they take when making loans.

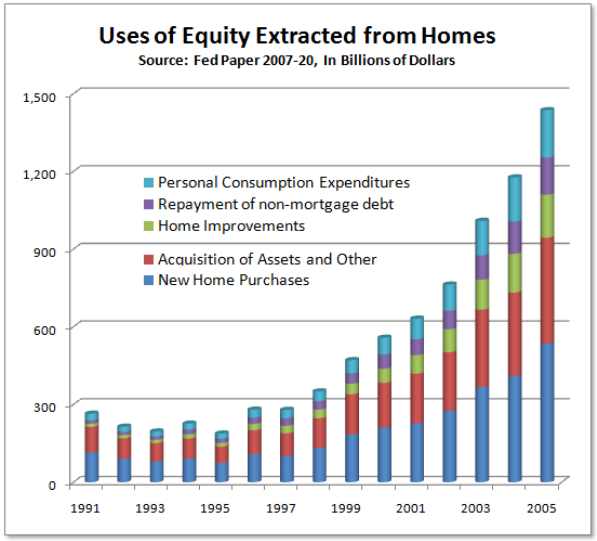
Moral hazard means that people are willing to take more risks if they think that they will not have to be responsible for the risks that they accept.

Origins of the Credit Crunch

The amount of outstanding debt in the UK is very high because people have borrowed to finance a high level of consumption.

- The increase in house prices that took place in the early years of the 21st century up to 2007 gave homeowners a lot of added value (equity) in their properties.
  - Many people borrowed on the strength of this to finance spending on items such as cars and holidays.
    - At that time, it was generally easy to get credit and consumption expenditure increased, creating new jobs and leading to increased employment.

- In the USA, this trend was even more marked.
  - Mortgage loans were granted by banks to people on very low incomes; this is known as the 'sub-prime mortgages' sector.
    - While interest rates were low, these people could meet their repayments
  - The banks that made the loans did so not because the borrowers could afford the loans
    - The loans were secured on the properties and the banks assumed that property values would not fall.

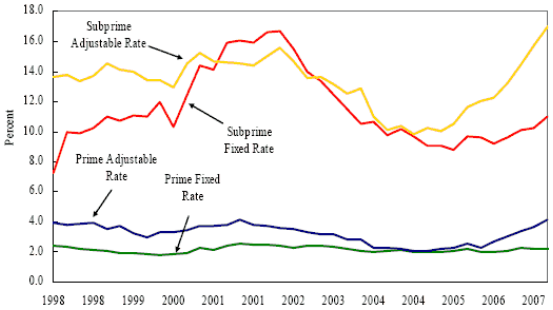


Origins of the Credit Crunch – debt securitisation

The banks were able to offload their mortgage debt onto other investors, freeing their capital up to offer yet more mortgages. This is known as "securitisation".

- The banks split their mortgages into pieces
  - These pieces were packaged up with pieces of other mortgages and sold as investments, like bonds
    - These were known as 'mortgage-backed securities', or MBSs)
      - Through this securitisation process, mortgage loans were spread around many lenders

- Interest rates rose in early 2007 in response to an increase in the rate of inflation. The rates on many loans increased at the same time.
  - People who had borrowed on a variable interest rate were facing increased monthly instalments and were finding it increasingly difficult to make their repayments.
  - Banks had not taken affordability into account when they made many of their loans, and people began to default on their mortgages, personal loans and credit cards.
    - Sub-prime borrowers in the USA and UK were unable to meet the higher repayments and defaulted.

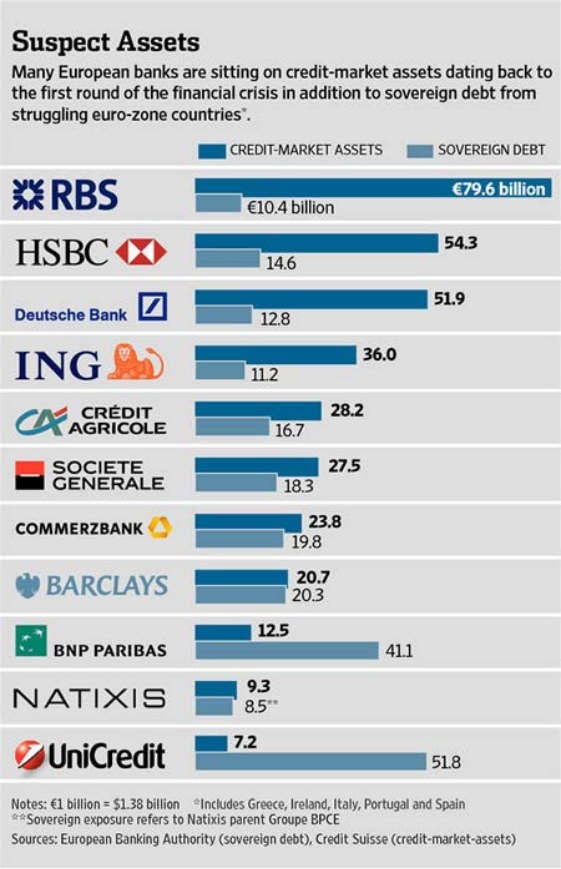


Comparison of Prime Versus Subprime Delinquency Rates, Total US 1998-2007

The Credit Crunch – contagion

With so many mortgage borrowers defaulting the future of many banks was threatened.

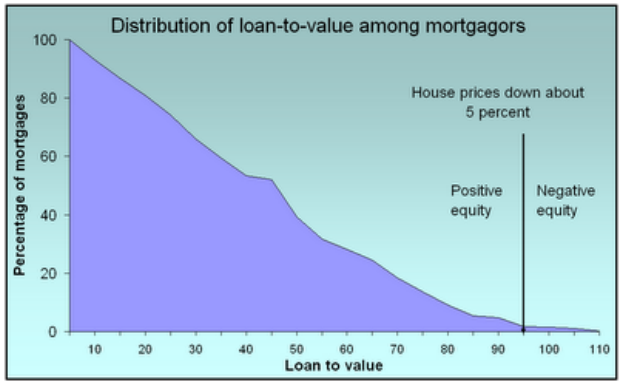
- The fact that mortgages had been securitised meant that the sub-prime debt had been passed around the financial markets.
  - This 'toxic debt' infected much of the system
    - A bank that had bought part of the debt was now holding worthless securities, even though the bank had not actually made the loans itself
- The contents of the MBSs had not been properly recorded and so the financial institutions that were left holding them when the crunch happened did not know whether they contained pieces of good mortgages or pieces of toxic ones.
  - The resulting uncertainty meant that banks stopped lending to each other, because they were unsure of each other's creditworthiness.
    - This caused a huge crash in financial markets. It also brought a number of banks to the edge of bankruptcy and some had to be bailed out by their governments.



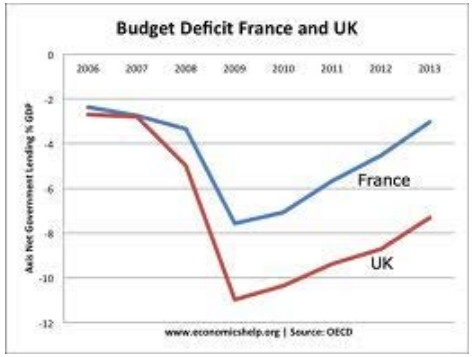
The Credit Crunch – collapse in house prices

With the rise in interest rates and financial markets crashing, house prices began to fall after a long period of boom during which they had soared.

- People who had borrowed against their equity found themselves owing more than the current market value of their home
  - This 'negative equity' meant that they were unable to sell their homes and therefore could not move until they had paid off more of their mortgage
    - Homeowners who actually defaulted still owed money to their banks even after their homes had been repossessed
      - People lost their homes and the savings that they had invested in them.



- Some banks failed others were rescued by governments in the UK and in other countries, or were sold off to bigger and safer banks.
  - Huge amounts of taxpayers' money were pumped into banks in order to keep them afloat
    - The UK's fiscal deficit (that is, the amount by which government expenditure is greater than tax receipts) increased hugely



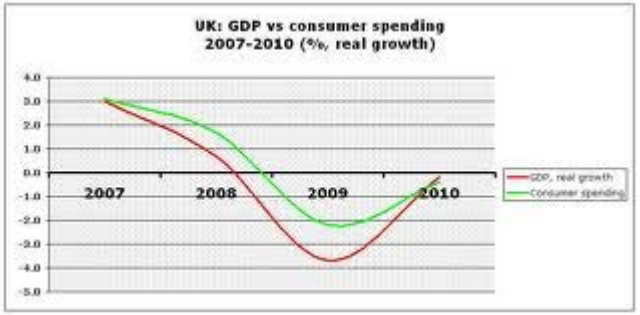
The Credit Crunch – government bail-out

In 2007-2008, the UK government had to rescue Northern Rock, Royal Bank of Scotland and Lloyds Banking Group.

- It believed that if it had not stepped in, there would have been a crisis of confidence and the whole financial system would have been under threat

  - The government had to borrow a lot of money in order to bail out the banks
    - It is now trying to reduce this borrowing by cutting public spending and increasing tax receipts.
      - One policy that was put into effect by the UK government in January 2011 was increasing the standard rate of value added tax (VAT) to 20%.

- Lenders have became very scared of further defaults and have tightened up their lending rules

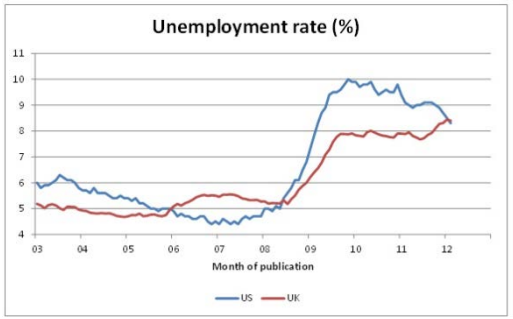


  - Consumer spending and investment has fallen as a result, and the economy has moved into a period of recession
    - A fall in consumer spending has a knock-on effect on the jobs of those who produce goods and services. Unemployment has risen sharply

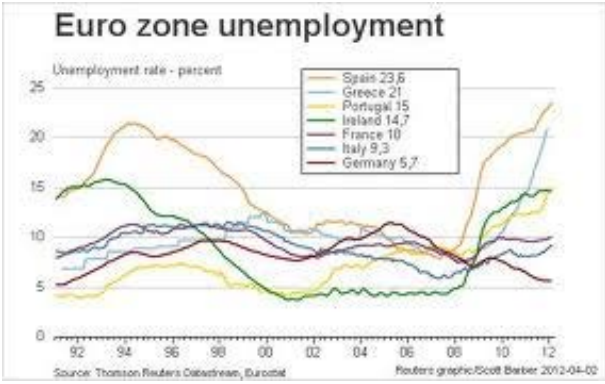
The Credit Crunch – recession

To encourage spending and investment, the Bank of England has kept interest rates at record low levels since 2009, but UK economic activity is still muted

- This has had a higher impact on certain geographical areas and occupational sectors, such as the North-East and the City of London financial sector
  - The policy of the coalition government to cut public debt by making large cuts in public spending is bound to result in higher unemployment.
    - Inflation had risen, but has fallen again, and the Bank of England believes that it will continue to fall throughout 2012



- There is also a lot of uncertainty over the effects on the UK economy of the debt crises in some Eurozone countries, especially Greece
  - The Eurozone crisis is still unfolding and it is important to follow the situation closely
    - A fall in consumer spending has a knock-on effect on the jobs of those who produce goods and services. Unemployment has risen sharply

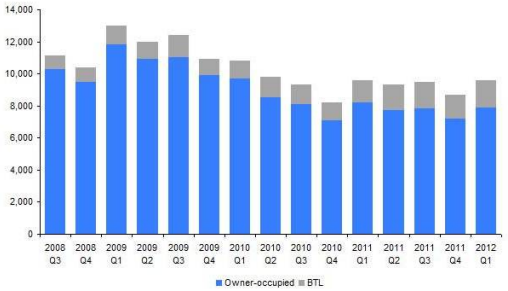


The housing market in the recession

Even though interest rates remain low, the housing market has not recovered and property prices have remained relatively low. This has hurt some owners:

- For some people, the fall in house prices has left them with **negative equity**
  - Negative equity arises when people owe more on a mortgage than their house is worth due to falling house prices

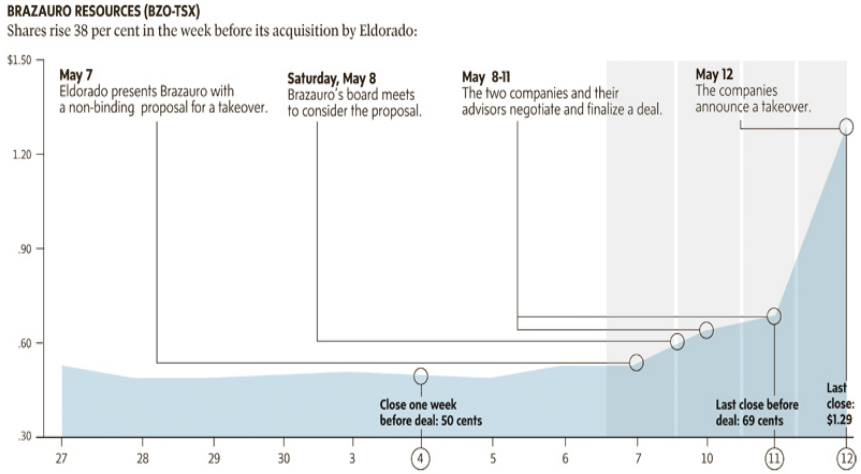
- Difficult economic circumstances – especially unemployment – mean that people may also find it more difficult to keep up with repayments and that there may be more **repossessions**
  - Repossessions occur when the lender takes possession of the security on the mortgage loan – that is, the house – because the borrower has not kept up repayments
- Some people may have taken out **second** or increased mortgages in the hope that house values would continue to rise
  - This has left them with even more debt and an asset with a declining value
- A big market in **'buy-to-let'** properties developed when prices were rising
  - Now many people are finding out that this was not such a sure investment



Insider dealing

Up to the end of the World War II the buying and selling of stocks and shares in a company on the basis of information known only to the company or its directors, officers and advisers was considered legitimate and was widespread.

Between the end of the World War II and the late 1950s it began to be considered unethical to make private profits at the expense of the main body of shareholders but in the 1960's and early 1970's the practice became widespread once more, often using inside knowledge of a take over.



- An insider is an officer or director of a company or any other person (such as a relative, or corporate financier or lawyer) who has access to private information about the company
- Insider dealing is said to have occurred when an insider buy or sells a security on the basis of information obtained “from the inside”
- Insider dealing is also known as “insider trading”.

Insider dealing

In 1973 The Stock Exchange and the Takeover Panel issued a joint statement calling for criminal sanctions for insider dealing. On 23 June 1980, The Companies Act 1980 came into force and made insider dealing a criminal offence in certain specified circumstances. The relevant act is now The Criminal Justice Act 1993

The Criminal Justice Act 1993 defines:

- who is deemed to be an insider
- what is deemed to be inside information
- The situations that give rise to the offence of insider dealing
- The penalties for people convicted of insider dealing

Maximum penalties for conviction under The Criminal Justice Act 1993

- 7 years for insider dealing
- an unlimited fine

The Financial Services and Markets Act 2000 also creates civil penalties for market abuse in parallel with the criminal offences

What is the definition of inside information?

Inside information is information that relates to particular securities, or a particular issuer of securities. The information must be

- ❑ Specific or precise
- ❑ It has not been made public
- ❑ If it were made public, it would be likely to have a significant effect on the price of the securities

PRIVATE AND CONFIDENTIAL

Project Grand-Slam

Summary:

The Board of Global Control plc has approved the hostile take-over bid for Minnow Enterprises plc. The bid will be launched on 26th February with an announcement to the London Stock Exchange at 8.00am that morning.

8.00am that morning.

The offer price will be 845p, a 36% premium to the average daily share price of Minnow Enterprises plc over the past 30 trading days. It is anticipated that 45m shares will need to be bought in the open market before the offer is declared unconditional.

Fisher MacLehose Bank has been given the mandate to buy the shares

The information is generally referred to as "unpublished price-sensitive information"

- ❑ The securities are generally referred to as the "price-affected" securities

COMPANY	LAST TRADED	BID	OFFER	SIZE
Jape Construction	39	38	39	70
Kleen Machine	138	138	139	70
Maybe Controls	1222	1221	1115	52
Minnow Enterprises	621	619	621	150
Posthumous Trading	109	109	111	45
Query Status	889	887	889	29
Terminal Systems	23	22	23	1110

When does information become public?

Information becomes public when it is published. For instance, a UK-listed company would publish price-sensitive information through the London Stock Exchange's Regulatory News Services (RNS)

NEWS RELEASE

Release Time IMMEDIATE
Date 16 February 2011
Number 04/11

BHP BILLITON RESULTS FOR THE HALF-YEAR ENDED 31 DECEMBER 2010

- **Record financial results including Underlying EBITDA(1) up 60% to US$17.3 billion, Underlying EBIT(1)(2) up 74% to US$14.8 billion and Attributable profit (excluding exceptional items) up 88% to US$10.7 billion.**
- **Strong margins and returns reflected by the increase in Underlying EBIT margin(3) to 46% and Underlying return on capital to 41%.**
- **The consistent deployment of capital towards high quality growth projects delivered half yearly production records across three commodities and five businesses.**
- **Operating cash flow(4) of US$12.2 billion and an ungeared balance sheet supports significant investment in organic growth that is expected to exceed US$80 billion over five years.**
- **A 10% increase in the interim dividend to 46 US cents per share.**
- **An expanded capital management program of US$10 billion.**

However, information can also be treated a public even though it could acquired only by experienced professionals actively looking for it

- ❑ Careful analysis of published accounts
- ❑ Searching through a web-site
- ❑ Scouring a library
- ❑ Reading one national newspaper

Definition of inside sources

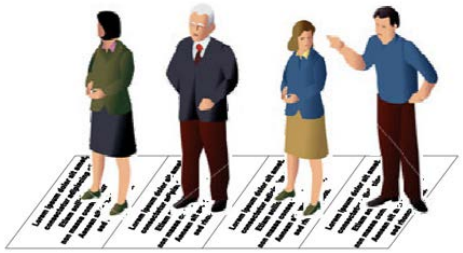
Inside information has to come from an inside source

Inside sources comprise the following:

- ❑ Director, or shareholder of an issuer of securities

- ❑ Employee, officer or professional adviser to an issuer of securities

- ❑ A third party, (perhaps a spouse, or friend) who has been given the inside information by an insider (i.e. one of the above)



All these people are deemed to be “insiders” and must not use any price-sensitive information that comes into their possession as a result.

Recent cases

The FSA is cracking down hard on people suspected of insider dealing

FSA fines former journalist £150,000 for market abuse

By LUCY FARNDON
Last updated at 9:49 PM on 7th February 2011

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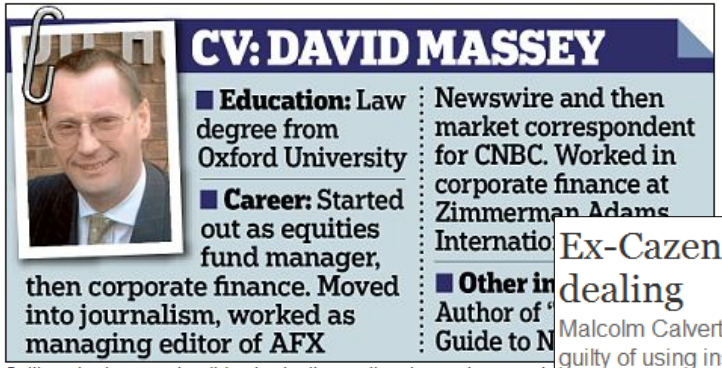
A former head of the AFX Newswire, now part of Thomson Reuters, has been fined £150,000 by the Financial Services Authority for market abuse.

David Massey has been banned from working in a regulated financial services role as well as hit with a hefty fine, because of his share dealings in relation to Eicom, a now defunct digital broadcaster, which used to be listed on the AIM market.

The watchdog said Massey sold 'short' 2.5m shares in Eicom at 8p per share in November 2007 'on the basis of inside information that Eicom was intending to issue new shares at 3.5p'.



Selling short means he did not actually own the shares, however h
short position 'within a matter of minutes' by accepting an offer to s
new Eicom shares.

This meant he made a £100,000 profit on the shares, by selling at
buying back at a low price.

At the time of the share deal, Massey was working as a corporate fi
Zimmerman Adams International.

Dresdner banker Christian Littlewood blames wife for insider trading

An attempt by shamed investment banker Christian Littlewood to blame the bulk of his illegal trading on his wife has been rejected by the courts.

s jailed for three years and four months

Ex-Cazenove worker jailed dealing

Malcolm Calvert, who retired from Cazenove 10 years ago, und guilty of using insider information to buy shares between 2003 and 2005

A former partner at the Queen's stockbrokers was jailed for 21 months today after being convicted of insider dealing.

Malcolm Calvert, who retired from the investment bank Cazenove 10 years ago, used an unknown insider to get confidential information on a series of proposed takeovers and mergers.

He then directed his friend Bertie Hatcher to buy shares in three firms, making the pair more than £100,000 profit, Southwark Crown Court in London heard.

Sentencing the 65-year-old, Judge Peter Testar said insider dealing was not a victimless crime.

Market abuse

The offence of market abuse was introduced by the Financial Services and Markets Act 2000. It was subsequently amended by the Market Abuse Directive of 2005.

Market abuse relates to behaviour by a person or group of people working together in relation to certain specified types of investments on certain specified markets.

- The behaviour is based on information that is generally not available to those using the market
  - And if it were available, it would have an impact on the price of the investment

- The behaviour is likely to give a false or misleading impression of the investment's …
  - Supply
  - Demand
  - Value

- The behaviour is likely to distort the market in the investment

Market abuse (cont.)

In a nutshell, market abuse is what a regular user of the market would view as a failure to observe the standards of behaviour normally expected in the market

In some ways, it is a qualitative measure that harks back to the days in the City of London when one's good reputation was essential to being able to do business

❖ Case study

- ❑ Read the case study and then answer the questions

Activity 3.4

Martin and Hayley bought a flat in 2002 for £50,000 with a £48,000 repayment mortgage over 25 years. In 2006, property prices had risen and other similar flats in their area were selling for £100,000. In 2007, Martin and Hayley borrowed £20,000 to buy a new car and a computer for each of their two children, and to go on an expensive family holiday. They increased their mortgage by this amount.

a) What was Martin and Hayley's equity in their property when they bought it?

b) What was their equity in 2006, taking into account the new value of the flat before increasing the mortgage and bearing in mind that they had paid off £8,000 of the original loan by this time?

c) What was the equity in 2007, at the 2006 valuation and with the increased mortgage?

d) Property prices collapsed in 2009, and the value of Martin and Hayley's flat returned to the amount that they had paid for it in 2001. What was their equity then? (Assume that they had paid off another £1,000 by that time.)

e) Advise Martin and Hayley on whether it was a good idea to increase their mortgage in order to finance their purchases.

f) By 2012, the flat has recovered some of its value, but the housing market is still quite depressed and the flat could lose more value. Economic output is still quite low. What do you think is one of Martin and Hayley's biggest worries in this situation?