

Executive Summary

Introduction

The research project presented in 2007 for the admission to the PhD Programme was primarily focused on the new developments in the integration of European financial markets, with special focus on MiFID and its future developments. The rationale of the proposed multidisciplinary approach aimed at analysing market developments in order to highlight new regulatory and supervisory issues that could have brought markets to failure. The original idea was built around two important concepts in financial regulation: best execution and market transparency.

However, the current financial crisis, started in the second quarter of 2007, changed the original plan of this research project. With my tutor's agreement, I decided to change a bit the target of my research project. The new research idea was aimed at applying the interdisciplinary approach - typical tool of law and economics - to place under scrutiny the real causes of the current financial meltdown. My research has been focused on deepening regulatory, supervisory, behavioural and informational issues that generated distorted structures of incentives and market failures in major areas of financial markets.

Therefore, I identified three potential roots of the recent financial crisis. The first paper – which I wrote as thesis of the EMLE Master Programme in August 2008 and thoroughly revised for this final submission - points out the failures in the mechanisms of origination and securitisation of US subprime mortgages. Subprime mortgages represent an important tool for wealth accumulation, but origination and distribution processes are affected by strong information asymmetries and cognitive biases (rational and irrational). Then, the second paper – which I wrote in the first half of 2009 and co-authored in the second part (on consumer policy) by Prof. Andrea Renda – represents a further step forward to assess critical aspects of the recent financial turmoil, *i.e.* widespread practices of misselling. The approach of law and economics that I hold in this essay aimed at illustrating the rationales for applying both antitrust and consumer protection legislation to tying, bundling and other potentially unfair commercial practices observed in the retail financial services

market. Finally, the third paper – which I wrote in the last 6 months – represents an overall overview of the huge over-the-counter market for derivatives. The gradual dominance of unregulated and unsupervised areas of financial markets on a global scale gave a great push to the widespread diffusion of the crisis across the world. Regulators thus are drafting new rules that will shape markets and business models in the future to come.

In conclusion, moral hazard and adverse selection have been the major informational problems that I pointed out during my research on the three topics previously mentioned. I may conclude that the whole financial system should learn from the lessons drawn by the recent financial crisis and understand how can be challenging the sophistication of modern financial markets. Decision-makers across world should work to design interventions more focussed on incentives and behaviours and less on products and market structure as such – more easily subject to legal and strategic circumvention - if they do not want to experience another collapse like the one is shaking this intricate global economy.

Paper 1

The Market for Subprime Lending: a Law and Economics Analysis of Market Failures and Policy Responses

Date: August 2008 (revised in November 2009)

In the aftermath of the subprime crisis, regulators are trying to design reforms able to fix market failures and reduce distortive incentives in this huge market. Subprime mortgages represent an important tool for wealth accumulation, but origination and distribution processes are affected by strong information asymmetries and cognitive biases (rational and irrational). The market for subprime mortgages mostly grew in a deregulated environment from the early 90s. It reached the peak in 2006, with a share of around 20% of the total mortgages originations in the US. The aim of this work is to analyse the subprime mortgages origination process (and indirectly its securitisation mechanisms) with the precious tools offered by the Law and Economics (L&E) and the principles of securities regulation. The new insights from the L&E doctrine on the implications of human behaviours and the new ways of “debiasing through law”¹ permit to analyse and propose remedies to the failures in the origination and securitisation process, in order to address weaknesses affecting their main actors. The theoretical aspects take stock of the empirical evidence showed by the crisis, as part of our adopted micro-approach, in the following

¹ See Jolls, C. and Sunstein, C. R., “Debiasing through Law” (March 2005). U Chicago Law & Economics, Olin Working Paper No. 225; Harvard Law and Economics Discussion Paper No. 495. Available at SSRN: <http://ssrn.com/abstract=590929>.

sections. We show as the failures of the subprime mortgages market were triggered by a mixture of irrational and opportunistic behaviours, as well as a lack of regulation, supervision and efficient disclosure.

This essay describes, on one hand, the complexity of the market, which is enhanced by borrowers' biases and low financial education *vis-à-vis* the specific characteristics of subprime mortgages as experience (or credence) goods. In effect, financial and behavioural aspects surrounding this transaction increase borrowers' misunderstanding of the real risk they are going to bear. On the other hand, a distorted structure of incentives for brokers, originator lenders and loans' packagers lead towards opportunistic behaviours, as "steering" and "churning"², for instance. Their opportunism consists in exploiting informational gaps and their contractually dominant power over the typical subprime borrower. The work mainly focuses on the origination process and implicitly on the securitisation mechanisms, which played a pivotal role in the widespread diffusion of troubled assets within the global financial system.

This paper, therefore, is structured in four parts. The first part briefly describes the financial architecture of the subprime market and the characteristics of the financial product, which shows the features of an experience (or credence) good. The second and the third part will deal with the major actors in the origination and securitisation process, highlighting the main points of failure that triggered the subprime crisis. Finally, the fourth part will give policy responses, promoting regulatory and supervisory actions *vis-à-vis* market initiatives and the legal recognition of a fiduciary relationship. These responses are designed to address moral hazard and adverse selection issues, acting on four areas: mandatory disclosure and simplification; suitability test and the "optional warranty"; assignee liability or retention mechanisms; reputational mechanisms and stronger supervision.

A better understanding of market failures and lessons drawn by the recent financial crisis should push knowledge into the regulatory process that aims at reforming the subprime market and other areas of financial markets so far not wisely regulated.

² "Steering" is a practice the placing of borrowers into unnecessarily expensive loans; see Ernst, Bocian and Li, 2008. The risk coming from this deceiving practice has been also recognised by the US proposal to introduce new rules for mortgages, now in the Senate; please, see House of Representatives, H.R. 1728, *Mortgage Reform and Anti-Predatory Lending Act*, May 2009, §103, Title I. "Churning" is basically a legal term to define a practice imported from securities regulation; SEC defined it as an "excessive buying and selling of securities in your account by your broker, for the purpose of generating commissions and without regard to your investment objectives", <http://www.sec.gov/answers/churning.htm>. It was firstly judicially defined in *Hecht v. Harris Upham & Co.*, 430 F.2 days 1202 (2nd Cir. 1970).

Paper 2

Legal and economic approach to tying and other potentially unfair and anticompetitive commercial practices: focus on financial services

Date: June 2009

The essay analyses the economic and legal aspects related to widespread practices as tying, bundling and other potentially unfair commercial practices in the financial services industry, with special focus on the European financial services market (without omitting the latest developments in the US market and case law). Therefore, the approach of law and economics that we hold in the essay aims at exploring rationales for applying both antitrust and consumer protection legislation to the practices subject to analysis in this paper and observed in the retail financial services market. Section 1 illustrates the main findings of the legal and economic theory as regards the applicability of antitrust rules to the practices at hand. This section also discusses the possibility to treat new commercial practices under antitrust law. Section 2 deals with the economics of tying, bundling and other unfair commercial practices from a consumer policy perspective, and reports empirical data on switching costs and patterns of consumer behaviour in retail financial services and in other sectors of the economy. We highlight sources of specific situations or cognitive biases that may be cause of rational ignorance and irrational behaviours in judgement and decision-making processes of a retail consumer. Section 3 proposes a new multi-stage test for the assessment of these practices under competition and consumer policy. We can draw two main conclusions in relation to the retail financial services market. Firstly, effects of the provision of these services on competition and consumer protection will vary depending on the characteristics of the service/product (or package of services/products) and the market. Secondly, all these factors potentially impact on customer's (actual or perceived) switching costs, and thus on customer mobility and choice.

The provision of financial services to retail investors, therefore, should balance tools of competition and consumer policy, as the impact of anticompetitive and/or unfair practices may harm customers' mobility, choice and welfare, thereby thwarting the integration of the European internal market.

Paper 3

Shaping Reforms and Business Models for OTC Derivatives Markets: Quo Vadis?

Date: December 2009

This paper sheds new lights on the OTC derivatives market and addresses specific policy conclusions that may back current proposals of reform for this unregulated area. In effect, regulators are setting new strategies to deal with its systemic importance, especially for financial and non-financial businesses, even though this market was not the spark that set off the chain reaction in financial markets. Risks, however, are diversified and may affect several stages along the value chain of a typical transaction, as well as weaken the economic and legal reasons behind their widespread use. Standardisation, centralisation of clearing and transparency through increasing use of data repositories are only some aspects that we are going to deepen, in order to understand the feasibility of forthcoming reforms. For instance, central clearing may be an efficient solution only for specific classes of assets, which perfectly fit with eligibility requirements, but not for all (standardised) financial products. The recent financial crisis showed us pro-cyclical aspects that may affect the market well-functioning again in the future. As response to these failures, EU and US regulators are drafting new rules to reshape OTC markets in order to keep the promise made at G-20 level to build a safer financial system. Despite the original commitment to draft uniform rules on a global scale, the two proposals in practice lay out divergent roads to comply with common objectives. On one side, these rules may change firms' business models, while - on the other - we question that they may leave potential space for regulatory and supervisory arbitrages. One thing is clear; regulators around the world will not leave OTC derivative markets "unregulated".

Finally, we conclude that regulators should aim at finding the right balance between the constraints set by a regulatory intervention and the freedom of market forces to lead markets - if wisely guided - towards efficiency and to design customised products for specific needs and risks, in order to boost economic growth and prosperity for the entire society.