4.4.2 Market failure in the financial sector

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

- Types of market failure in the financial sector:
    - Asymmetric information: one party in a financial contract had less information than the other party. Examples
        - Health insurance relies on accurate information but those seeking insurance have superior information about their own health
        - In banking, relatively few investors understood the risks of derivatives before 2008
        - In the stock market, there is differences in knowledge between buyers and sellers about the profitability of companies
    - Moral hazard: Before 2008, bankers traded highly risky securities to enhance their bonuses which resulted in massive losses and some banks had to be rescued by the government. This creates moral hazard because banks know they will be bailed out if they are in trouble so will continue risky behaviour
    - Speculation and market bubbles: Before 2008 interest rates were low, credit was easy to obtain and asset prices were rising. Banks created £1trn of new money between 200-2007 accompanied by a doubling of debt. There was a 'herd effect', which resulted in people buying assets in the hope of future gains even though these were unjustified in terms of their real worth
    - Externalities: it could cause asset bubbles which could be an external benefit to those with assets but it makes them more inaccessible for others (for example first time buyers)
    - Market rigging:
        - The LIBOR has been rigged
        - The FCA has accused traders at HSBC of colluding with traders from at least three other traders in an attempt to manipulate the sterling-dollar rate
- LIBOR (London Interbank Offered Rate): a benchmark interest rate based on the rates at which banks lend unsecured funds to each other on the London interbank market