Financial Crises and Regulatory Responses [B8347]

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Fall 2016: Tuesday, Thursday, 4:00-5:30, -- URI 307

There have been more than a dozen financial crises in the world since 1980, including six in the United States alone. What are the common elements among these crises, what are the differences? In some instances, crises have brought about significant regulatory reform. Yet how is it that financial crises seem to recur with such frequency? And recur despite regulatory efforts to avoid them.

In the past five years, each time our course has been given a major crisis or regulatory development was unfolding in real time, making our course particularly lively and relevant. One year our course was confronted with the developing Eurozone crisis. Last year the boom in fintech and the lendingclub crisis was one of the most relevant developments discussed in class. This year, we can expect Brexit and its fallout to be at the center of our discussions. In short a special quality of this course is the application of the material and general principles to a crisis unfolding in real time.

Using a mix of economic history, finance, and law-related materials we plan to address the following themes:

1) Are financial crises foreseeable or unforeseeable? Do they arise from processes internal to the financial sector (such as the “leverage cycle”) or from external events, such as changes in the political landscape that change the terms of financial globalization?

2) Are there more or less stable structures for the financial system? The financial system aims to match suppliers of capital (savers) and users of capital (business users and consumers). From a stability point of view, is such financial intermediation better done through financial institutions or through markets?

3) Is there an optimum size for financial institutions? Should certain financial market activities be combined (for efficiency and diversification) or separated?

4) Are we better off with rigorous schemes of crisis avoidance or efficient resolution mechanisms, if long periods of financial stability inevitably lead to increased leverage, asset price inflation and a resulting steeper crash? Perhaps we are better off by focusing attention on mopping up smaller, more frequent crashes?

5) Do recurrent crises flow from the political constraints on optimum regulation? There are two facets to this question. First, is the desire of incumbent political leaders to promote reelection chances by producing economic growth or greater home ownership, which favors expansionary credit policies. Second, is the firm-level competition within the financial sector
to protect and expand rents.

6) The financial environment is driven by the interplay of legislation, regulation, governance and monetary policy. To what extent can independent central bank intervention through monetary policy correct for legislative or regulatory debility?

7) Do the goals of differently tasked regulators conflict in a way that may undermine systemic stability? How does the disclosure focus of securities regulators fit with the safety and soundness goals of financial regulators, as evidenced for example in Bank of America and Merrill merger or the crisis era manipulation of Libor?

8) International coordination and its limits: do the concessions made to obtain sufficient national buy-in to achieve a widespread international regime (necessary to avoid free-riding) undermine the effectiveness of the international regulatory architecture? One example where this issue has arisen prominently in recent years is the zero risk-weighting on all OECD sovereign debt under the Basel accords.

What follows is a tentative syllabus that may be altered during the semester depending on events and the availability of guest speakers.

Books for Background Reading:

Ben S. Bernanke (2015 forthcoming), THE COURAGE TO ACT: A MEMOIR OF A CRISIS AND ITS AFTERMATH

Timothy F. Geithner (2014), STRESS TEST: REFLECTIONS ON FINANCIAL CRISES, Random House


Articles that are [*] are required reading. Other readings are recommended or for reference.

Note: the assigned readings will include material from Armour, Awrey, Davies, Enriques, Gordon, Mayer, and Payne, Principles of Financial Regulation (forthcoming 2016) (“PFR”)

You should acquire books from a bookstore or an on-line bookseller. Other Materials are web-posted
**Week 1: Are financial crises inevitable?**

Financial crises are common throughout history including recent history. What accounts for their frequency? Do they arise from causes **internal** to the financial system, or do they result from **external** events, unexpected and not foreseeable?

**Session 1.1: Confronting Financial Crises**

[*] Jeffrey N. Gordon & Christopher Muller, Confronting Financial Crisis: Dodd-Frank’s Dangers and the Case for a Systemic Emergency Insurance Fund, Yale J. Reg, 2011, pp. 155-177


Carmen Reinhart and Kenneth Rogoff (2009) **This Time Is Different: Eight Centuries of Financial Folly**, available on SSRN


**Session 1.2: The U.S. Savings and Loans Crisis**

At least 3 separate factors were at work in the S&L crisis: (i) an exogenous shock (here: high inflation (attributable at least in part to oil price shocks) and high short term interest rates); (ii) regulation and regulatory distortion that made the financial system vulnerable to the particular shock; and (iii) the politics of forbearance that exacerbated the crisis. Are these elements common to all crises?


**Week 2: Primer on the Financial Crisis of 2007-09**

Is the crisis of 2007-08 an out-of-the-blue, once-in-a-century episode, or is it just a larger scale manifestation of common causes underlying episodic financial crises? Has the crisis
been made worse because of novel organizational structures of modern financial institutions and global markets?
Session 2.1: Securitization and the Shadow Banking Sector

[*] PFR, Ch. 20, “Making Markets” (section on securitization)

[*] Adrian, T., A. Ashcraft, H. Boesky and Z. Pozsar, Shadow Banking, Revue d' Economie Financiere 105 (2012)

Joshua Coval, Jakub Jurek & Erik Stafford, The Economics of Structured Finance, 23 J. Econ. Persp. 3 (2009)


Keys, B., T. Mukherjee, A. Seru and V. Vig, Did Securitization Lead to Lax Screening? Evidence from Subprime Loans, Quarterly Journal of Economics (2010)


Session 2.2: The Subprime Panic


[*] PFR, Ch. 20, “Making Markets” (section on wholesale funding markets)


Week 3: The First Responses to the Financial Crisis of 2007-09

How did policymakers respond to the crisis? What were their immediate concerns and how were their interventions restricted by the existing regulatory framework?

[*] Timothy F. Geithner (2014), STRESS TEST: REFLECTIONS ON FINANCIAL CRISIS [chapters 4, 5, 6]

Session 3.1: The Bear Stearns Rescue and section 13(3) of the Federal Reserve Act

Session 3.2: The Lehman Brothers Collapse, AIG, the run on Money Market Mutual Funds and TARP

[*] Gordon & Muller, Avoiding Eight Alarm Fires, 41-48
Coffee, The AIG Case: Moral Hazard on Steroids
[Gordon & Gandia, Money Market Funds Run Risk: Will Floating NAV Fix the Problem?, 2014 CBLR 313, 314-316

Week 4: Liquidity Transformation and Crises

Are financial markets and financial intermediaries fundamentally unstable? Is greater financial stability achieved by matching investments and investors through financial institutions or through markets? (The readings below are more technical than other readings on the syllabus. Students are not expected to master all the details of the analysis in these papers. Reading the introductions of these articles should be sufficient. A key article is Diamond & Dybvig.


Weeks 5-7: The Political Economy of Financial Crisis

The focus of the next 2 ½ weeks will be the interaction of political economy and regulation in financial regulation. Political economy plays a critical role in four respects: first, as shaping government behavior that creates the pre-conditions for a financial crisis; second, in limiting enforcement under existing laws that could restrain excesses of market actors; third, in shaping the reform proposals in the legislative phase; fourth, in shaping the implementation of the proposals in subsequent regulation. We will consider this interaction generally and then turn to two specific depression era reforms, deposit insurance and Glass-Steagall. Along the way we will also consider the “fitness” of the adopted reforms for their intended purpose.

5.1 The Political Economy of Crisis Creation


5.2 The Political Economy of Crisis Resolution: The Case of Mortgage Foreclosure Relief for the Crisis of 2007-09


6.1 The Political Economy of Shaping Legislation: The Example of Deposit Insurance


Carnell et al’ THE LAW OF BANKING AND FINANCIAL INSTITUTIONS, Ch 6 (Deposit Insurance)

6.2 The Political Economy of Shaping Legislation: Glass-Steagall and the separation of commercial and investment banking

[*] Glass-Steagall, §§ 16, 20, 21, 32

[*] ICI v. Camp, 401 U.S.617 (1971)

7.1 The Political Economy of Implementation: Glass-Steagall; its loopholes and its unravelling

Loretta Mester, “Repealing Glass-Steagall: The Past points the way to the Future” (1996)

McCoy, §§7.01, 7.02[1]; 7.04[2]

Glass-Steagall Act chronology

**Weeks 7-10: The Regulatory Response to the Financial Crisis of 2007-09**

The 2 ½ weeks devoted to the regulatory responses to the financial crisis of 2007-09 will discuss the main goals of policy makers and assess the main changes in the financial regulatory landscape. What are the new tools available to regulators? How do the new regulations resolve the main weaknesses in the financial system before the crisis? Have the new regulations overreached and excessively stifled the financial industry? Where are the remaining loopholes and areas of vulnerability?

**7.2 Dodd-Frank: Ensuring the Stability of the Financial System as a whole**

[*] Dodd-Frank §§ 101-123, 151-156, 165-176; as codified at 12 USC 5321-33; 5341-45; 5363-5374.

[*] Dodd-Frank Summary and Summary of the Financial Stability Oversight Council, excerpt from Sullivan & Cromwell Dodd-Frank memo

FSOC 2014 Annual Report Executive Summary

Tarullo, Macroprudential Regulation (Sept. 2013)

Brunnermeier & Oehmke (2012), “Bubbles, Financial Crises & Systemic Risk” (Focus on the last section, on systemic risk, p. 60 et seq.; otherwise, read for general understanding, without deep dive into formal models)


**8.1 Dodd-Frank: Systemic Stability through Regulation of Large Banks**

[*] Dodd-Frank § 165, 12 USC sec. 5365.
[*] Davis Polk memo on the Fed’s EPS Regulation, including visual aids.

Board of Governors, Enhanced Prudential Standards for Bank Holding Cos. and Foreign Banking Organizations (Summary and Introduction)

Sullivan & Cromwell memo on the Fed’s EPS Regulation

8.2 Pre-Dodd-Frank: Resolution Option and the end of bailouts?


Thomas C. Baxter, Jr. (2013), “Resolving the Unresolvable: The Alternative Pathways to Ending Too Big to Fail”


9.1 Resolution Under Dodd-Frank: The End of Bailouts?

[*] Davis-Polk, Orderly Liquidation Authority Excerpt

[*] Dodd-Frank, Title II, §§ 204, 206; 203(a),(b), (c)(4); 202 (a), (d); 210 (a)(1)(A)-(N); 210(a)(2)(A),(B); 210(a)(3)(A)(i),(D); 210(a)(11),(12); 210(b)(1),(2)(4),(5); 210(c)(8)(A),(C),(D)(i),(F),(G); 210(c)(9); 210(c)(11); 210(c)(3)(C); 210(c)(12),(13),(16); 210(f); 210(g); 210(n); 210(o); 210(s).

[*] Cutbacks in pre-existing rescue authorities outside of OLA: Federal Reserve Act §13(3); FDIC guarantee authority.

Gordon & Muller (2011), 190-204

Wallison, Dodd-Frank Will Produce More Bailouts

9.2 Dodd-Frank: Implementing OLA


“The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act”, FDIC Quarterly (2011)

Jeffrey Gordon and Georg Ringe (2014), Bank Resolution in the European Banking Union: A Transatlantic Perspective on What it Would Take


**10.1 Bank Regulation: Regulating the Asset Side – the Volcker Rule and TBTF**

[*] Dodd-Frank, § 619, Volcker Rule


Dudley (2012), “Solving the Too Big to Fail Problem”


James Barth & Apanard Prabha (2012), “Breaking (Banks) Up is Hard to Do”


Andrew Haldane (2012), “On being the ‘Right Size’”

**10.2 Bank Regulation: The Rights Hand Side of the Balance Sheet**


Week 11: Grappling with the “Shadow” Banking System: Credit Intermediation Outside the Official Banking Sector

11.1 Bank Regulation and Shadow Banking


Pozsar, Adrian, Ashcraft and Boesky (2012), “Shadow Banking”


Ed Morrison & Mark Roe (2014), “Rolling Back the Bankruptcy Safe Harbors”

11.2 Money Market Fund “Reform”


SEC Money Market Fund Reform Summary (2014)


Week 12: Financial Stability and Monetary Policy

The Federal Reserve and other central banks have played a key role in the early phase of the crisis of 2007-09 by providing a liquidity backstop to financial institutions and thus avoid a generalized panic. Monetary authorities have also responded to the crisis by sharply lowering interest rates and maintaining a lax monetary stance of a prolonged period. Is monetary policy an essential complement to financial regulation to maintain financial stability? Or does the liquidity backstop of central banks play a destabilizing role by facilitating the appearance of new bubbles?

12.1 Monetary Policy as a Complement or Substitute for Financial Regulation

[*] Neil Irwin (2013), THE ALCHEMISTS: THREE CENTRAL BANKERS AND A WORLD ON FIRE
12.2 Corporate Governance of Financial Institutions

Rather than impose rigid structural constraints on bank balance sheets and banking activities could the regulation of bank governance and bankers’ incentives not be equally effective and less intrusive? Does bank governance require a different approach to the governance of non-financial institutions? Should financial incentive schemes of bankers be regulated?


Board of Governors, Enhanced Prudential Standards for Bank Holding Cos. and Foreign Banking Organizations (Summary and Introduction) (Review Material on Risk Management Committees)

Mark Roe (2014), “Structural Corporate Degradation Due to Too-Big-To-Fail Finance”