LGST 243/643

Other People's Money: The Regulation of Financial Institutions and Markets

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Office Hours: Tuesday 3pm – 5pm

Course Description:

"We have, for better or for worse, adopted a system in which financial companies are privately or mutually owned and then regulated in the public interest in order to make them internalise costs which might otherwise be borne by others."

-- Sam Woods, Deputy Governor for the Bank of England's Prudential Regulation Authority (May 2019)

The global financial system is comprised of myriad financial institutions and markets. This system has evolved rapidly over the past ten years, and much of that change has been driven by regulation enacted after and in reaction to the global financial crisis of 2008. Consider, for example, that banks used to be the main source of credit in the economy; but, now, in reaction to the regulation that followed the crisis, banks have pulled back from many of their traditional financial activities and other 'nonbank' financial institutions have filled that space. Still, more changes are on the horizon, with the rise of financial technology and a new generation of non-financial risks, like cyber threats and climate change.

This course will equip you with the basic knowledge and vocabulary that you will need to navigate this labyrinth of institutions, markets, laws and regulation.

In short, this course will be your tour through the financial system, and the legal and regulatory frameworks that apply to it. So you will finish the course with a solid understanding of the main 'players' in the financial system (how they are connected, and how they interact), the context behind its current structure, and the opportunities and challenges of its future.

No background in finance, law, or economics is required. Yet those with such background(s) will not be bored.

Grading:

Your grade is divided into three parts: 25% class participation, 25% for debate and case study preparation and delivery, and 50% for the final exam *or* final project.

Class participation. Your class participation grade will primarily be determined by the quality of your comments in class (meaning, how engaged with the reading, how responsive to other students, and how focused on the "discussion questions" which appear on the syllabus), your attendance, and your punctuality. I will take attendance and start each session precisely on time and will make a note of any latecomers or missing students each session for grading purposes.

If personal emergency or job interviews mean you'll have to miss class or arrive less prepared, please notify me at least an hour before the beginning of the session. Abuse of this notification system will be noted. See me of course with any concerns.

Debates. In addition to giving you a foundational knowledge of the financial system, this course will push you to engage in high-level conversation about contentious issues. We will be engaging with matters that are neither clearly settled nor obvious. You will need to understand the underlying matters and be aware of, and able to engage critically with, the arguments for and against particular positions. The best way to engage critically with the issues is to debate them with others coming from a different perspective.

Debates will be scheduled and structured as follows. For each topic that we cover, one or two of the sessions will be dedicated to debating a hot-button issue. On those "debate" sessions, you will find a "debate" question on the syllabus. You will be placed in a debate group with four or five of your colleagues. In the week before the debate is to take place, your group will be assigned a position (either "for" or "against" the proposition to be debated) for which you should then prepare a defense. On the day-of the debate, two groups will be randomly selected to present their respective positions to the class. The rest of the class will be given the opportunity to ask questions of the presenters, and at the end to add any points that were not made. Further details will be discussed in session one.

Cases. I assign five cases in the syllabus. For two sessions, the case study is assigned as <u>the</u> class. In those cases, my expectation is that you will read the case and prepare the associated questions for in-class discussion. I will call upon two groups to "present" their cases. In two other sessions, I've assigned a case as part of the session's reading. In those classes the case should be read and reflected on to inform our in-class discussion, in the ordinary course.

Final Project or Exam. There will be an option to complete a final project in lieu of a written exam. The final project will be to choose a specific financial institution or piece of financial regulation and provide a legal or policy assessment. Examples might be a specific country's central bank (the Bank of England, for example), a specific regulation (the Volcker Rule, for example), or something similar. The assessment should be 3,000 words. I expect that each student will do one project, but will entertain group projects. In that case, the word count will be multiplied by the number of students.

Required Text and Readings:

Almost all required texts (as listed by lecture below) will be available through Canvas.
The exception is the following book:

- John Armour et al., *Principles of Financial Regulation* (Oxford University Press, 2016) [abbreviated to "*PFR*" in the assigned readings].

The book provides an excellent, accessible guide through the financial system and we will use this book as our 'home base.' The book is available electronically for free, as well as in the Penn bookstore.

Optional Preparatory Material:

There is a lot of specialist terminology concerning the various components of the financial system. These readings will give you an overview if you would like to read them before the start of classes. These readings are optional, not required.

- *PFR*, chapter 2.

- Robert Shiller, *Finance and the Good Society* (Princeton University Press, 2013), Part One (pp. 19-130) (incidentally, the rest of the book is also well worth reading as a thoughtful, if inconclusive, introduction to many phenomena we will encounter). It is available here.

The Financial Crisis motivated a great deal of the regulation that we will study. As such, it is a kind of 'super case study' that gives context to much of what we will cover in the course. It will be invaluable for you to have some insight into what went wrong. These two texts will give you a solid sense.

- Gary Gorton, 'Questions and Answers about the Financial Crisis', testimony prepared for the US Financial Crisis Inquiry Commission (2010) (A summary of the views of the economist who has arguably done most to explain the key mechanisms that propagated instability).

- Tim Geithner, *Stress Test* (Crown Publishers, 2014) (again, this is optional, and will not be on the exam; but it is a very readable eyewitness account from one of the most crucial players for those interested in knowing more).

Finally, if you have no background in economics, you may wish to do some supplementary reading in order to become comfortable with the language of market failure analysis, which we adopt in the course.

- Chapter 3 of Armour et al, *Principles of Financial Regulation*.
- I also strongly recommend that you read Anthony Ogus, *Regulation: Legal Form and Economic Theory* (1994, reissued without revisions in 2004), Chs 2-4 (the library has just purchased an e-copy and the link will be circulated soon).

Lectures and Assigned Readings:

Topic 1: Introduction to The Financial System

To kick off the course, we'll start by discussing the main components and structure of the financial system. In the first class, we'll gain an understanding of the main mechanisms by which savings are channelled into investment: via financial markets and financial institutions (or intermediaries). Our first goal in these sessions is descriptive: to understand the terrain of the landscape. Our second, and more important goal, is analytic: to be aware of the limitations in the functioning of each mechanism. This analytic discussion will help us to understand the rationale(s) for regulatory intervention in financial institutions and markets.

Session 1: Financial System Structure, Aims, and Architecture

Readings:

a. *PFR*, chapter 2

b. Gary Gorton, 'Questions and Answers about the Financial Crisis', testimony prepared for the US Financial Crisis Inquiry Commission (2010) (re-read if you did not do so before term)

Discussion Questions:

a. What is the primary purpose of the financial system?

b. If markets and banks can both channel funds from savers to real investment projects, does it matter which we use?

Session 2: Goals and Challenges of Financial Regulation

Readings:

a. *PFR*, chapters 3, 4.3 and 4.5

b. John C. Coffee, *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, 97 Cornell Law Review 1019 (2012) (introduction and Part I only).

Discussion Questions:

a. Are there drawbacks to using market failure analysis to frame financial regulation?

b. What should policymakers do when the goals of regulation are in tension?

Session 3: Debate

"Financial regulation should be subject to cost-benefit analysis."

Topic 2: **Insured Depository Institutions (Banks)**

This set of lectures examines the core economic functions of banks, along with the risks stemming from the credit, liquidity, and maturity transformation which they perform. We will also discuss the basic regulatory strategies which have been developed to address these risks: emergency liquidity assistance (or 'lender of last resort') regimes, deposit guarantee schemes, and risk-based capital requirements. In this topic, we will also explore the internal mechanisms of bank "regulation," that is, the governance of a bank and its compliance function.

Session 4: **Economic Function of Banks**

Readings:

a. *PFR*, chapter 13.2.1

b. Federal Reserve Bank of San Francisco, What is the Economic Function of a Bank?

c. Speech, Mark W. Olson, Governor, Board Governors of the Fed. Reserve System *Are Banks Still Special*, Mar. 13, 2006,

Discussion Question:

a. Banks "create" money. What implications does this function have for how we approach the regulation of banks?

b. Why does a bank's capital structure matter for financial stability?

Session 5: **Bank Regulation and Governance**

Readings:

a. *PFR*, chapters 13.2.2-13.5, 14.1, 15.1, 17.1

b. Case: "Deutsche Bank and the Road to Basel III"

Discussion Questions:

a. How should policymakers balance the need for a stable financial system with the risk of "moral hazard"?

b. Should policymakers focus their limited resources on "panic-proofing" the financial system, or on preventing the build-up of debt bubbles?

Session 6: **Debate**

"Banks should be required to hold more capital." (*PFR* chapters 14 and 15, and last week's case, will provide essential background; additional readings may be suggested.)

Session 7: **Case Study on "Compliance"**

"Respect for Control Functions"

Topic 3: "Shadow Banking" (i.e., Market-based Credit Intermediation)

After the 2008 financial crisis, the term "shadow banking" came to be used to refer to a broad range of financial institutions that perform liquidity and maturity transformation outside of the banking sector. But the term, and its negative connotations, have come under scrutiny in the past few years. In this topic, we'll study some of the major players in the "shadow banking" world: investment funds, investment banks, and structured financial products (and their associated markets). We'll ask whether these institutions and activities pose economically similar risks to those generated within the conventional banking system, and whether the regulatory strategies applied to banks should be extended to this so-called "shadow" banking system.

Session 8: Asset Managers and Investment Funds

Readings:

a. *PFR*, chapter 20

b. Suzy Waite, Annie Massa & Christopher Cannon, *Asset Managers With $74 Trillion on Brink of Historic Shakeout*, Bloomberg (August 8, 2019)

Discussion Questions:

a. What risks do open-ended mutual funds legitimately pose?

b. Do these risks require further regulatory intervention, or might the market find a solution?

Session 9: Private Equity (with Guest Speaker, Managing Director from Blackstone Real Estate Group)

Readings:

a. Case: "Blackstone at Age 30"

Discussion Questions:

a. [Prepare three to five questions for our guest speaker, based on your reading of the case or outside knowledge]

Session 10: Securitization and Structured Finance Markets

Readings:

a. *PFR*, chapter 21

b. Case: "Blackstone and the Sale of Citigroup's Loan Portfolio"

Discussion Questions:

a. [Case Questions will be assigned the week prior, for in-class discussion]

Session 11: Case Study on "Contagion"

"Rosalind Z. Wiggins & Andrew Metrick, *The Lehman Brothers Bankruptcy H: The Global Contagion* (Apr. 2015)"

Topic 4: Regulating "Nonbank" Financial Institutions and Market-Based Credit Intermediation

Investment banks and investment funds have always been subject to a range of regulation, which is implemented and enforced principally by the SEC. But after the financial crisis, lawmakers and regulators began to discuss the bank-like risks that these institutions can pose—and, in reaction to that view—instated a host of new kinds of financial stability regulation for (or inquiries into) these institutions.

Session 12: Securities Regulation

Readings:

a. *PFR*, chapters 5, 8

b. Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 Duke Law Journal 712 (2006) (Part I and Part II)

Discussion Questions:

a. What is (or should be) the primary goal of securities regulation?

b. How effective is disclosure at addressing some of the risks in the financial system that we have identified in the class so far?

Session 13: Financial Stability Regulation

Readings:

a. Christina Parajon Skinner, *Regulating Nonbanks*, 105 Georgetown Law Journal (2017) (introduction)

b. Financial Stability Board, Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities (2017)

c. Harv. Law School Forum on Corp. Governance and Financial Regulation, FSOC Designation Treasury Report: A Fundamental Shift (2018)

Discussion Questions:

a. Should the FSOC focus on entities or activities that pose potential financial stability risks?

b. Is the FSOC a useful addition to the regulatory regime?

Session 14: Debate
"Asset managers pose systemic risk."

Topic 5: **Information Intermediaries and Financial Market Infrastructure**

In these lectures, we will get into the plumbing of the financial system. First, we will consider those institutions that act as information intermediaries therein. We will also discuss the new trading environment, characterized by a multiplicity of venues where the same securities are listed and liquidity is mainly provided by high frequency traders.

Session 15: **Investment Banks and Rating Agencies**

Readings:

a. Testimony of Lloyd Blankfein, CEO of Goldman Sachs, Financial Crisis Inquiry Commission, January 13, 2010 (p. 6-11)

b. Lawrence J. White, *Markets: The Credit Rating Agencies*, 24 Journal of Economic Perspectives 211-226 (2010)

Discussion Question:

a. What role do credit rating agencies play?

b. Are investment banks beneficial to the economy?

Session 16: **ATFs/MTFs, High Frequency Trading, DLT**

Readings:

a. Guido Ferrarini & Paolo Saguato, *Regulating Financial Market Infrastructures*, *in* The Oxford Handbook of Financial Regulation 568-81 (N Moloney, E Ferran & J Payne eds., 2015)

b. Merritt Fox, Larry Glosten, & Gabriel Rauterberg, *The New Stock Market: Sense and Nonsense*, 65 Duke Law Journal 191 (2005) (introduction, Part I and Part II).

Discussion Questions:

a. How are traditional stock exchanges different from alternative trading systems (ATS)? What are the trade-offs associated with ATSs/MTFs?

b. What are the regulatory challenges associated with new financial infrastructure?

Session 17: **Debate**

“Regulators should not be involved in the regulation of DLT technology; in this area, markets are better off without them.”

Topic 6: Central Banks

Central banks are most commonly thought of in their monetary policy setting capacity. But central banks today play many roles and, increasingly, are responsible for macro financial stability. We will consider the structure and mandates of two of the world's most prominent central banks – the U.S. Federal Reserve and the U.K.'s Bank of England. We will then discuss some of their key roles: as resolution authority, supervisor, and manager of payments systems. We will also consider the work of international networking bodies of national central banking authorities.

Session 18: The Fed and the Bank of England

Readings:

a. Peter Conti-Brown, The Power and Independence of the Federal Reserve (2016) (introduction and Chapter 1)

b. Michael Salib & Christina Parajon Skinner, *Executive Override of Central Banks*, 108 Georgetown Law Journal (forthcoming 2020) (introduction)

Discussion Questions:

a. What makes a central bank independent?

b. Do we always want a central bank that is independent (entirely) from the executive branch's influence?

Session 19: Supervision and Resolution

Readings:

a. Thomas Eisenbach et al., Fed. Reserve Bank of New York, *Supervising Large, Complex Financial Institutions: What Do Supervisors Do?* (May 2015)

a. Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (Oct. 2014).

b. Reuters, *Rushed Popular Resolution Casts Long Shadow Over Europe's Banks*, June 7, 2019

c. Speech, Vice Chairman Stanley Fischer, *The Lender of Last Resort Function in the United States* (Feb. 10, 2016)

Discussion Questions:

a. How effective can supervisors be at anticipating and preventing the kinds of mirco and macro risks that we've discussed so far?

b. Reflect again on the "LOLR" function of the central bank. What role should the LOLR tool play alongside supervision and resolution?

Session 20: Payments (Old and New)

Readings:

a. Ryan Tracey & Lalita Cloze, *Federal Reserve Floats Proposal to Modernize Its Payments Systems*, Wall Street Journal (Oct. 3, 2018)

b. Lawrence Baxter, *Hooray for Bitcoin (but Don't Buy it)*, Wall Street Journal (Dec. 11, 2017)

Discussion Questions:

a. Who should be responsible for a nation's payments systems – the central bank or private actors?

b. Is Bitcoin a hoax, or a revolutionary technology?

Session 21: International Financial Regulation

Readings:

a. The Basel Committee – Overview, https://www.bis.org/bcbs/

b. About the FSB, https://www.fsb.org/about/

Discussion Question:

a. What is the value of these international regulatory bodies?

b. Do they threaten the sovereignty of the individual nation states?

Session 22: Debate

"Central Banks should be responsible for financial stability policy and regulation."

Topic 7: Consumer Protection

There is a host of regulation that focuses on the regulation of consumer financial products (like mortgages and credit cards) and generally seeks to protect the retail investor. In these sessions, we will consider the metes and bounds of this body of regulation and the new regulatory body created to address consumer protection.

Session 23: Consumer Financial Products

Readings:

a. John Y. Campbell et al., *The Regulation of Consumer Financial Products: An Introductory Essay with Four Case Studies* (June 27, 2010) (Parts I – IV)

Discussion Questions:

a. What are the main rationales for regulatory intervention in consumer financial markets?

b. Are these rationales compelling?

Session 24: The Consumer Financial Protection Bureau

Readings:

a. Leonard J. Kennedy, Patricia McCoy & Ethan Bernstein, *The Consumer Financial Protection Bureau: Financial Regulation for the Twenty-First Century*, 97 Cornell Law Review 1141 (2012)

b. *The CFPB, Born in Controversy, Becomes a Farce*, The Economist (Nov. 30, 2017)

Discussion Questions:

a. Is the CFPB a useful addition to the post-crisis framework?

b. How could its design be improved?

Session 25: Debate

"The CFPB should be disbanded."

Topic 8: The Future of the Financial System

In our remaining two classes, we'll discuss the future risks to the stability and resilience of the financial system. What's coming next for financial regulation?

Session 26: Nonfinancial Risk

Readings:

a. Piotr Kaminski et al., Nonfinancial Risk: A Growing Challenge for the Bank (July 2016)

Discussion Questions:

a. What is the most pressing kind of nonfinancial risk facing the financial sector today? Should regulation seek to address it now?

b. How does climate change affect banks?

Session 27: FinTech

Readings:

a. Yuka Hayashi, *Judge Denies Federal Agency's Authority to Issue FinTech Bank Charters*, Wall Street. Journal, Oct. 22, 2019

b. Rory Van Loo, *Making Innovation More Competitive: The Case of Fintech*, 65 UCLA Law Review 232 (2018) (Parts I, II and III)

c. FCA, Regulatory Sandbox, https://www.fca.org.uk/firms/regulatory-sandbox [browse site]

Discussion Questions:

a. How are fintech companies or platforms disrupting traditional financial services and institutions?

b. How should fintech be regulated?

Session 28: Mop-up and exam review