GLOBAL FINANCIAL REGULATION

Professor: Howard DAVIES
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BIOGRAPHICAL INFORMATION

Teacher's name: Howard DAVIES
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He has been teaching in Science Po since 2011. He is the Chairman of the Royal Bank of Scotland and is on the main board of Prudential Plc. He is a former Chairman of the Financial Services Authority and Deputy Governor of the Bank of England.

COURSE OUTLINE

Session 1 - (+2) Introduction and An Anatomy of the Crisis

What are the main components of the financial system? The growing financialisation of the global economy. The trends that led to the crisis of 2007. The explosive growth of derivatives markets. The explosion of mortgage credit in (some) markets. Increasing product complexity and opacity. Inadequacy of risk management in firms. The failings of ratings agencies and accountants. The nature of the collapse when it came.

Primary Text:
"The Financial Crisis: Who’s to Blame“. Howard Davies

Session 3 - Global Financial Regulation

What was the global regulatory system pre-crisis? How did it evolve? How did international, regional and national bodies relate to each other? The role of the International Financial Institutions (IMF and World Bank). The changing role of central banks. The role of the Financial Stability Forum, set up after the Asian crisis. The changing structures of regulation in individual countries.

Primary Text:

Session 4 - Regulatory Problems revealed by the Crisis

Why did the regulatory system (broadly defined) fail to moderate these trends? The failings in monetary policy. The inadequacy of bank capital. The under-regulation of derivatives markets. The failure of regulators to keep up with product innovation and to understand the risks inherent in new products. Weaknesses in international co-ordination.

Primary texts:

Session 5 - Global Financial regulation. Changes post-crisis and where next?

The Crisis precipitated long overdue changes in the architecture of global financial regulation. The G20 took over from the G7 as the key political body. The Financial Stability Board was renamed and given a new role of co-ordinating the activities of sectoral regulators. How will these changes affect the character of regulation? What will the attitudes of the new participants be? The shifting centre of the world's financial and economic gravity could have major consequences quickly in this area.

Is the new system likely to be any more stable and effective than the old? Why have the changes not been more radical? Some argue that the FSB/IMF relationship needs attention, and that the IMF should be at the centre of the regulatory system. Others believe the FSB needs further strengthening and a stronger institutional basis. Is there a serious collective action problem? What further changes might make sense?

Primary text:

Can Financial Markets be Controlled? Howard Davies

Session 6 - Regulation of Bank Capital

The most significant change in regulation post-crisis has been the imposition of large increases in capital requirements for banks. Regulators argue this will make the system more robust, and that the impact on banks overall cost of capital will be modest. (Following Modigliani and Miller). Some economists have argued for even higher levels of capital. Banks argue, by contrast, that the cost of capital and credit will rise, and that there will be an impact on credit availability, cost and therefore on economic growth. They are pushing back strongly in the US and in Europe. How do we assess these arguments? Is there a point of diminishing returns where additional capital requirements will become counterproductive? Is there a risk that regulators give further stimulus to the shadow banking market, thus making the system less stable rather than more robust?
Session 7 - Too Big to Fail

It is argued that banks faced an asymmetrical risk calculation pre-crisis. In other words, that as they took on more risk they could earn higher profits, knowing that if things went wrong the taxpayer would bail them out, through deposit protection schemes or the lender of last resort, or indeed capital injections. But do banks really behave as if they think they are too big to fail? Has the new regulatory system resolved the problem, if it exists?

Will “living wills”, which banks are now obliged to draw up, be effective? Will contingent convertible debt instruments work as intended, and create additional capital when times are tough? Can bail-ins be made to work? What of the cross-border dimension? Without harmonised bankruptcy arrangements can cross-border resolution work at all? What are the arguments for and against requiring a separation of investment and retail banking, and perhaps separate subsidiarisation of retail operations. How do we evaluate the Volcker rule, another attempt to address the issue? Is that an effective halfway house?

Recommended reading:
Executive Summary of the Independent Commission on Banking Final Report. (12 September 2011)

Session 8 - European Financial regulation – work in progress?

The De Larosiere report proposed three new authorities at European level (ESAs). They have now been put in place, but without European deposit protection. The ECB is now the main banking supervisor in the Eurozone, as a Banking Union has been established, but without European deposit protection. The EC is now revising the operation of the ESAs. Are further changes needed to make regulation of the Eurozone more robust.

Primary text:

Session 9 - Corporate governance in banks

Both corporate governance and risk management in banks failed, and that there was a link between the two failings. In the US and UK changes are under way to strengthen board oversight of risk management, with banks obliged to introduce new risk committees. How much reliance can we place on independent directors and boards? What structure makes most sense, and what types of people? (There are a number of studies of the relationship between boards and success or failure in the crisis). What should boards actually do to be effective? How can regulators best encourage directors to do a better job?

Primary text:
Session 10 - World Financial Centres

What impact will the post-crisis environment have on the location of financial activity? For a long period, New York and London have dominated many areas of wholesale markets? They now face stronger competition from Asian centres, though other European centres have struggled to make an impact.

What can we expect over the next decade? Has regulatory competition been an important feature of the battle between centres? If so, what can be done to enhance the enforcement of global standards?

Within Europe, how will the structure of financial activity change? Can London remain the most important centre after Brexit? Where will large banks be located in future? Arguably it will no longer be possible to locate large cross-border banks in small centres, following the debacles in Iceland and Ireland? Which countries are strong enough to host major banks in future? Is even the UK too small to play host to a genuinely global bank? Might Europe need a pan-European lender of last result to stand behind its global banks? If not, is there a risk that European banks will be marginalised by US competitors and by new huge banks based in China?

Session 11 - Bankers pay

Why has pay risen so fast in the financial sector in the last two decades, far more rapidly than in the economy as a whole? Why has that happened particularly in the US and the UK? Is there a failure of competition, as we would normally expect very high rents to be competed away by new entrants prepared to undercut? Is this part of the reason for rising inequality?

Have banks deliberately made their services hard to understand and unnecessarily complex, to enhance prices? Are corporate customers at fault for being unwilling to bargain prices down? Are technological factors to blame, creating a new “winner takes all “ phenomenon? Should the tax system have responded more aggressively? Various countries have attempted to regulate bonuses in different ways ? What can we learn about the effectiveness of these attempts? What are the political consequences of the growing income inequality created by this trend, and the deep unpopularity of the financial sector in and since the crisis?

Primary text:
Wages and Human Capital in the US financial industry. NBER 2009.

Session 12 - The Future of Finance

How will financial markets develop in the next 20 years? Has the peak of financialisation passed? Are the critics who question the social utility of much financial intermediation correct? Is Paul Volcker right to say that the only genuinely useful innovation in the last three decades has been the ATM? Or will constraining financial development through tighter regulation have damaging long-term consequences for growth and employment?