



## **The Financial System**

MULT- UB.0027.01 & .02

Fall 2013

Sect.01 M-W 11:00 – 12:20 KMC 4-90

Sect.02 M-W 2:30 – 3:50 KMC 4-80

Profs. Roy C. Smith and Ingo Walter

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### **Course Description:**

Recent global financial turbulence has demonstrated both how important the financial system is to the world economy and how complex it is.

Financial systems are centered on key institutions, instruments and markets. But they also involve governments, public policy and regulation. They span the globe from the US, the EU and Japan to Russia, China and the Emerging Markets. In critical ways, country-level financial architectures are integrating to form a more seamless, high-performance whole. This is good for efficiency, innovation and growth, yet it also amplifies problems during times of crisis.

This course provides students with a broad and rigorous understanding of (i) How the global financial system works and what purposes it serves, (ii) What the major elements are and how they operate, and (iii) What challenges the global financial system creates for public policy makers. In seeking to achieve these objectives, this broad-gauge course provides a perspective that helps students understand and make the most of their own professional opportunities. Along with a working knowledge of the global macroeconomy, foundations of finance and corporate finance, this course will be extremely helpful for students as a lens to focus on the key dimensions of the modern business environment.

### **Faculty:**

Roy C. Smith is *Kenneth Langone Professor of Finance and Entrepreneurship* and a former partner of Goldman, Sachs & Co. and President of Goldman Sachs International.

Ingo Walter is *Seymour Milstein Professor of Finance, Corporate Governance and Ethics*.

The course has an integrated design, with Prof. Walter responsible for leading the discussion during the first half of the course and Prof. Smith responsible for the second half.

### **Schedule:**

The class meets on Mondays and Wednesdays, with sections scheduled for Mondays at 11.00 am – 12.20 pm and 2:30 – 3.50 pm respectively. The first class is on September 4<sup>th</sup> and the last class is on December 11th. In case of serious scheduling conflicts students in one section of the course may request permission from the instructors to attend the other section on an exceptional basis.

### **Class Participation:**

We like to teach with lots of classroom discussion and initiatives taken by individual students to research things that are of interest to them and bring them up in class.

### **Course Requirements:**

The course requires two individually authored 1,000-word “Op-eds” submitted by each student. No group work. No use of material from other sources without quotation marks and with careful footnoting and attribution to avoid questions of plagiarism.

There is also a group project to be submitted at the end of the course. Groups will be formed and projects selected early in the course; the deliverable will be in the form of a PowerPoint presentation not to exceed 10 slides. Each group will present its project report in class during the last two sessions of the course.

And, finally, there are closed-book mid-term and final examinations.

### **Textbook & Readings**

Students are required to purchase the following textbook:

Roy C. Smith, Ingo Walter and Gayle De Long, *Global Banking* (New York: Oxford University Press, 2012). Available from the NYU Bookstore. Denoted GB.

Alan Blinder, *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead* (New York: Penguin, 2012). Chapter 13, "The Backlash." Available from the NYU Bookstore.

"Course packet: Available from the NYU Bookstore. Denoted CP.

All other material for the course is posted on NYU Classes under "Resources." (Not in sequence.) Denoted NYUC. The URL is:

<https://newclasses.nyu.edu/portal/site/ef8aa036-3aa9-4d85-b0d7-12e05a7a5d8b/page/40baba14-407b-47f6-8cb4-c39310c36806>.

### **Grading:**

At NYU Stern, we strive to create courses that challenge students intellectually and that meet the Stern standards of academic excellence. To ensure fairness and clarity of grading, the Stern faculty has agreed that for elective courses the individual instructor or department is responsible for determining reasonable grading guidelines. The grading weights for this course are as follows:

- Op-eds (2) 20%
- Group project 20%
- Midterm exam 25%
- Final exam 25%
- Class participation 10%

The Stern Finance Department has elected to use the following grading guidelines for this course and all other elective courses. Instructors must award grades of "A" or "A-" to approximately 35% of students in elective courses with enrollments of more than 25 students.

### **General Conduct and Behavior:**

Students are expected to maintain and abide by the highest standards of professional conduct and behavior. Please familiarize yourself with Stern's Policy in Regard to In-Class Behavior & Expectations (<http://www.stern.nyu.edu/portal-partners/current-students/undergraduate/resources-policies/academic-policies/index.htm>) and the NYU Disruptive Behavior Policy (<http://www.nyu.edu/about/policies-guidelines-compliance/policies-and-guidelines/bullying--threatening--and-other-disruptive-behavior-guidelines.html>).

## **Academic Integrity Above All:**

Integrity is critical to the learning process and to all that we do here at NYU Stern. As members of our community, all students agree to abide by the NYU Stern Student Code of Conduct, which includes a commitment to: (a) Exercise integrity in all aspects of one's academic work including, but not limited to, the preparation and completion of exams, papers and all other course requirements by not engaging in any method or means that provides an unfair advantage. (b) Clearly acknowledge the work and efforts of others when submitting written work as one's own. Ideas, data, direct quotations (which should be designated with quotation marks), paraphrasing, creative expression, or any other incorporation of the work of others should be fully referenced. (c) Refrain from behaving in ways that knowingly support, assist, or in any way attempt to enable another person to engage in any violation of the Code of Conduct. Our support also includes reporting any observed violations of this Code of Conduct or other School and University policies that are deemed to adversely affect the NYU Stern community.

The entire Stern Student Code of Conduct applies to all students enrolled in Stern courses and can be found here: [www.stern.nyu.edu/uc/codeofconduct](http://www.stern.nyu.edu/uc/codeofconduct)

To help ensure the integrity of our learning community, all assignments that you submit via the course's NYU Classes website will be routed through Turnitin, which will compare your submission to a database of prior submissions, current and archived Web pages, periodicals, journals, and publications. Your document will automatically become part of the Turnitin database.

## **Students with Disabilities**

If you have a qualified disability and will require academic accommodation of any kind during this course, you must notify the instructors at the beginning of the course and provide a letter from the Moses Center for Students with Disabilities (CSD) at Tel. (212) 998-4980 or [www.nyu.edu/csd](http://www.nyu.edu/csd)) verifying your registration and outlining the accommodations the Center staff recommends. If you will need to take an exam at the CSD, you must submit a completed Exam Accommodations Form (EAF) to them at least one week prior to the scheduled exam time to be guaranteed the alternative venue.

## Course Outline

<u>Session</u>	<u>Topic (Date and Instructor)</u>
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1.	Banks and Banking – 4 September 2013 (Walter)
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- Financial intermediation in the real economy.
- Core banking functions and maturity transformation.
- What is a bank?
- Are banks special?
- Banks as fiduciaries.
- Banks, money creation and the transmission belt for monetary policy.

Readings:

NYUC – Anthony Saunders & Marcia Cornett, *Financial Institutions Management* (New York: McGraw-Hill, 2010), Chapter 1.

2.	Banking as a Business – 9 September 2013 (Walter)
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- How to make money from banking.
- Managing Harry's boring bank.
- Transforming it into Harry's dynamic bank.
- Credit quality and bank solvency.
- Betting on rates.
- Funding the bank and the role of repos.
- Asset-liability management.
- Managing liquidity, capital and leverage.
- How banks fail ... and then what happens?

Readings:

NYUC – Anthony Saunders & Marcia Cornett, *Financial Institutions Management* (New York: McGraw-Hill, 2010), Chapter 2.

Video: Frank Capra, "It's a Wonderful Life" (1947) accessible at <http://www.youtube.com/watch?v=frXkIECPkD0>

3. The Short History of US Banking – 11 September 2013 (Walter)

- The big chapters in the book of banking.
- Banks and the building of a nation.
- Banking's heroes and villains.
- Golden eras of banking.
- Shocks, panics and busts.
- Causes and consequences of bank bailouts.
- How today's modern banking system got here.

Readings:

NYUC – Richard Sylla, "Reversing Financial Reversals: Government and the Financial System since 1789," ch. 5 in Price Fishback, et al., *Government and the American Economy: A New History*, U of Chicago Press, 2007, 115-47.

4. How to Save and Manage Assets Without Banks – 16 September 2013 (Walter)

- The buy-side of modern financial systems.
- Key asset classes and how to get at them.
- Hiring money managers: Pension funds. Mutual funds. Hedge funds. Private equity and alternative assets. Sovereign wealth funds.
- Managing other people's money and fiduciary responsibility. Private banking and helping the rich stay rich.
- Competitive performance and who keeps score?

Readings:

GB – Chapters 9-11

NYUC – Roy Smith and Ingo Walter, *Governing the Modern Corporation* (New York: Oxford University Press, 2006), Chapter 6.

5. How to Borrow and Raise Capital Without Banks – 18 September 2013 (Walter)

- The sell-side of modern financial systems.
- Alternatives to bank financing and how they have evolved.

- The basics to debt and equity capital markets and the key functions – origination, trading and market-making, and distribution.
- The rating agencies and secondary markets.
- The origins and evolution of investment banking.
- Advisory functions, proprietary investments.

Readings:

GB – Chapters 4 and 5.

#### 6. Universal Banking and Financial Conglomerates – 23 September 2013 (Walter)

- Universal banking before the Great Depression.
- The crash of 1929, the waterfall of bank failures and the Pecora Hearings of 1933.
- What to do?
- The Banking Act of 1933, deposit insurance and the Glass-Steagall provisions.
- The Securities Acts of 1933 and 1934 and the Investment Company Act of 1940.
- Postwar deregulation and the Gramm-Leach-Bliley Act of 1999. What's the answer: Is bigger better? Is broader better? Is bigger and broader safer and more competitive?
- Should big and complex financial firms be broken-up?

Readings:

NYUC – Anthony Saunders and Ingo Walter, ““Reworking the Global Financial Architecture: Is Universal Banking the Best Way Forward?” *Journal of Financial Perspectives*, April 2013.

**Group Project Proposals Due**

## 7. The Financial Architecture – 25 September 2013 (Walter)

- Putting it all together.
- The role of derivatives and synthetics.
- Flow of funds analysis of modern financial systems.
- The key role of securitization.
- The US in global perspective – the battle of financial systems and financial centers.
- Balancing financial efficiency, innovation, fairness, stability and robustness – what are the tradeoffs?

Readings:

GB – Chapter 12.

## 8. Who Makes the Rules? – 30 September 2013 (Walter)

- Key players at the national level – Federal Reserve, Comptroller of the Currency, Federal Deposit Insurance Corporation, CFTC, state regulators, etc. Congressional committees.
- The special case of housing finance, FHLB, Sallie Mae, Fannie Mae, Freddie Mac.
- The role of political economy, lobbying and the public interest.
- Small changes in regulation create big changes in financial systems.
- Important players at the international level, notably the Bank for International Settlements and the G-20 Heads of State.
- The role of self-regulatory organizations (SROs).

Readings:

GB, Chapter 15.

## **Op-ed #1 Due**

## 9. The Financial System and Macroeconomic Policy – 2 October 2013 (Walter)

- Macro-policy targeting.
- Real-sector policy levers.
- Monetary policy levers and the “transmission belt.”
- Why the financial architecture is important.



- Interest rates, inflation rates and exchange rates.
- Policy targeting, execution and volatility in rates.
- How countries get into and out of trouble.
- Country risk analysis.

Readings:

GB, Chapter 13

### Group Project Proposals Approved

#### 10. System Failure and The Financial Crisis: The Forensics - 7 October 2013 (Walter)

- The perfect storm.
- The “Greenspan put,” the credit bubble and leveraging the system.
- Chasing Alpha.
- Due diligence in housing finance.
- The “Toxic Twins” – Fannie & Freddie.
- The securitization machine and financial innovation.
- Regulatory arbitrage and regulatory capture.
- Helpers – fees, fees and more fees.
- Investors on autopilot.
- How banks lost their way – pipelining versus warehousing.
- Liquidity collapse and marking to market.
- Globalization of losses.
- “Manufacturing” systemic risk.
- Crisis management and the fog of war – Bear Stearns, Lehman Brothers, the TARP, AIG, money market funds, commercial paper and all the rest.
- At the end of the day, “it’s the government, stupid.”

Readings:

NYUC - Viral V. Acharya and Matthew Richardson (eds.), *Restoring Financial Stability* (New York: John Wiley & Sons, 2009), Prologue, “Bird’s Eye View.”

NYUC - W. Scott Frame and Lawrence J. White, “Fussing and Fuming Over Fannie and Freddie: How Much Smoke, How Much Fire?” *Journal of Economic Perspectives*, Volume 19, Number 2 (Spring 2005).

11. System Failure and The Financial Crisis – The Consequences - 9 October 2013 (Walter)

- Impact of financial turbulence: Damage to financial system integrity.
- The real economy. Who lost the money – shareholders, home-owners, institutional investors, fiduciary clients and why grandparents have to work way into their 70s.
- Who didn't lose the money – subordinated debt-holders, favored counterparties, some hedge funds, senior execs and many bankers.
- Modern finance – wealth-creating or wealth redistributing?
- Fiscal balance and the taxpayer.
- Bankers on the skids – sliding down the social pecking-order. And nobody went to jail.

Readings:

NYUC – Long Term Capital Management Case Profile

NYUC - Viral Acharya, Thomas Cooley, Matthew Richardson, Richard Sylla and Ingo Walter, "The Dodd-Frank Wall Street Reform and Consumer Protection Act: Accomplishments and Limitations." *Journal of Applied Corporate Finance*, Vol. 23, No. 1. Winter 2011.

NYUC-- Film: Charles Ferguson, "Inside Job" (2010)

**14 October – No Classes**

12. **Midterm Exam - 16 October 2013**

13. Stabilizing the Financial Architecture - 21 October 2013 (Smith)

- After the bleeding stopped: Pointing fingers rethinking the efficiency/robustness balance.
- Lobbyists, lobbyists and more lobbyists – acting for the public interest in the real world of political economy.
- The US Dodd-Frank Law of 2010 and its implementation. Basle III.
- National regulatory initiatives in globalized financial markets.
- Breaking-up the banks?

Readings:

Alan Blinder, *After the Music Stopped*, Chapter 13, "The Backlash."

14. Post-crisis - 23 October 2013 (Smith)

- Where do we stand on US regulation, markets, industry reorganization?
- Affects on capital markets, investment banking.

Reading:

CP - Alan Blinder, *After the Music Stopped*, "Chapter 17 "Never Again, Legacies of the Crisis."

15. The Financial System in Europe – Evolution of the Euromarkets - 28 October 2013 (Smith)

- Before the EU
- The world's first and only unregulated securities market
- Integration of global markets

Readings:

GB – Chapter 1.

16. Global Financial Integration 1 – 30 October 2013 (Walter)

- Financing Mrs. Takahashi's vacuum cleaner.
- Linking national commercial banking markets globally.
- Cross-border banking – why banks set up shop abroad.
- Underpinning the global real sector – from trade to project finance.
- How banks finance each other.
- Clients and products – the global financial cafeteria.

Reading:

GB - Chapter 3.

NYUC - Case: Federal National Mortgage Association (NYUC)

17. Global Financial Integration 2 – 4 November 2013 (Smith)

- Vast liquidity pools,
- Bubbles, massive market forces
- Before and after the crisis
- “Balkanization of capital markets?”

Reading:

NYUC - McKinsey Global Institute, “Mapping Global Capital Markets 2013”

18. The Financial System in Europe – 6 November 2013 (Smith)  
Evolution of the EU and the Euro

- Why the EU was formed
- Political factors shape the system
- Birth of the Euro
- The Euro before the crisis

Reading:

NYUC - Roy C. Smith, “Agony of the Euro,” *The Independent Institute*, Summer 2013

19. The Financial Crisis in Europe – 11 November 2013 (Smith)

- Government interventions, EZ bailouts
- Financial crisis in Europe
- Iceland, Greece
- Ireland, Portugal
- Spain and Italy

Read:

CP - Michael Lewis: *Boomerang* Chapters 1 and 2.

**Op-ed #2 due.**

20. The Financial Crisis in Europe – 13 November 2013 (Smith)

- Structural flaws appear
- Sovereign debt in distressed countries
- Bank solvency in the distressed countries
- The “vicious cycle”

Reading:

CP - Alan Blinder, *After the Music Stopped*, Chapter 16. “The Big Aftershock – The European Debt Crisis”

21. Rethinking Global Financial Regulation – 18 November 2013 (Smith)

- Capital adequacy for banks increased
- Basel III, extra efforts in Switzerland and the UK
- Ring-fencing
- Compensation and governance issues

Reading:

NYUC - *The Vickers Committee Report*

22. Financial Systems in Asia – 20 November 2013 (Smith)

- The Japanese model
- China’s vast financial system

Reading:

CP - Roy C. Smith, *Comeback*, Chapter. 7, “The Rising of the Sun”; and  
CP - Carl Walter & Frasier Howie, *Red State Capitalism*, Chapters 1 & 2.

23. Disruptive Forces – 25 November 2013 (Smith)

- Unregulated “shadow banks”
- Operating globally

Reading:

NYUC -- Excerpts from Annual Reports of BlackRock and Blackstone)

24. Disruptive Forces – 27 November 2013 (Smith)

- How technology affects financial markets
- Dark pools, information asymmetries
- Regulatory issues related to technology

Reading:

NYUC - Report on merger of NYSE and ICE, Annual Report of Liquidnet, Slidedeck: Big Data in Financial Services.

25. Managing Risk – 2 December 2013 (Smith)

- Old and new forms of risk
- How they are managed in a rapidly changing environment

Reading: (To be determined)

26. Future of Financial Systems – 4 December 2013 (Smith)

- Where the system stands today
- Cyclical affects
- Structural change in the financial service industry
- Changes to business models

Reading:

NYUC -- Roy C. Smith, “Global Banking After the Cataclysm”

- 27. Group Project Presentations 1 – 9 December 2013 (Smith & Walter)
- 28. Group Project Presentations 2 – 11 December 2013 (Smith & Walter)

**Final Exam (16-20 December 2013 Per Schedule To Be Announced)**