

# **Bank Regulation and Resolution of Banking Crises**

## **Module Introduction and Overview**

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## 1 Introduction to the Module

Welcome to this module, *Bank Regulation and Resolution of Banking Crises*. The module has been designed to introduce you to some of the key concepts, principles and practices in modern banking regulation and the resolution of modern banking crises. The literature on these subjects is vast so, in approaching the material, we will focus on a selection of key issues of relevance to the topic.

The link between regulation and crises has recently moved from abstract discussion and specialists' technical papers to popular debate and headline news; and new regulation-related concepts, such as 'systemic risk' have been topics for talk shows as well as political campaigns. The surprising change in its status results from the widespread perception that the systems of bank regulation carefully constructed up to 2007 failed to achieve the objective of systemic stability; the regulators have been seen as having turned a blind eye to problems that had been building up for years and have literally exploded, giving way to the Global Financial Crisis (GFC) that emerged in the US in early 2008 and spread to a number of other countries, with worldwide effects on real economic activity.

The Global Financial Crisis had its roots in 2007, developing further in 2008, and it took a dramatic turn for the worse as a result of the failure of US investment bank, Lehman Brothers, in September 2008. The resolution of the crisis is still, at the time of writing in 2016, in the course of being fully resolved with diverse outcomes in different countries. Faults in bank regulation were not the direct or only cause of the GFC, but the crisis has led policy makers and academics to attempt to restructure regulation systems so as to minimise the risk of further occurrences. This module introduces some of the reform proposals but, as debates continue, none are final.

Each unit will introduce its own objectives. Integral to each unit's study material covering these topics are the core readings prescribed. Our strong advice is that you plan your work carefully to ensure that you have enough time to study those readings thoroughly.

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## 2 The Module Authors

**Dr Alessandra Dal Colle** holds graduate and postgraduate qualifications in economics and finance, and is currently credit risk manager in charge of developing a Basel II advanced credit rating model for social businesses in a major European bank. She has also worked on designing stock and derivatives exchanges in research departments of banking institutions, and has spent some research time at the United Nations UNU – WIDER centre in Helsinki, working on finance and development. Dr Dal Colle has been lecturing and tutoring in banking and finance for over 15 years.

**Laurence Harris** is Professor of Economics in the University of London and contributes to CeFiMS as a member of the Department of Financial and

Management Studies, SOAS University of London. He has previously taught at several universities including London School of Economics; University of California Berkeley; Harvard University; Birkbeck, University of London; the Open University; University of Zimbabwe. He has published nine books and eighty articles. Books include *Monetary Theory; New Perspectives on the Financial System; City of Capital; and Peculiarities of the British Economy*.

**Dr Cyrus Rustomjee** was formerly Director, Economic Affairs Division, Commonwealth Secretariat and head of the Centre for Economic Training in Africa (CETA) based in Durban, South Africa. In South Africa he has been Chairperson of the Policy Board for Financial Services and Regulation, which advises the Minister of Finance on all aspects of the South African financial system; Chairperson of the Financial Services Board, which regulates the country's non-bank financial sector, and member of the Standing Committee for the Revision of the Banks Act. He has served as Executive Director for 21 African countries in the Executive Board of the IMF (1998–2002). He has also been a member of the World Bank Executive Board (1996–98); Advisor to the Deputy Minister of Finance in South Africa (1994–1996); Corporate Bank Manager (1984–91); and Technical Expert in drafting the financial clauses of South Africa's new Constitution (1995/96). Dr Rustomjee holds graduate and post-graduate qualifications in economics, law, politics, banking and finance.

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### 3 Study Resources

This study guide is your central learning resource as it structures your learning unit by unit. Each unit should be studied within a week. It is designed in the expectation that studying the unit and the associated core readings will require 15 to 20 hours during the week, but this will vary according to your background knowledge and experience of studying.



#### Key text

In addition to the study guide, you will be assigned chapters in the following core text, which is provided for you.

Allen N Berger, Philip Molyneux & John OS Wilson (2014) *The Oxford Handbook of Banking*. 2nd Edition. Oxford UK: Oxford University Press.

#### Module readings

The additional reading you are required to complete, together with your study of the module units, is a selection of academic articles and extracts from books, journals and documents. The module readings are often more technical, or adopt a more in-depth approach on particular topics than the text of the study guide. This should not put you off, as many were written with an academic audience in mind. These articles were selected so that the central arguments and concepts can be understood and appreciated at a level appropriate to this module.

## Optional readings

You are provided with access to all the reading essential for this module, and we do not expect you to undertake extra reading on your own, partly because not all students have ready access to good libraries or bookshops. However, the reference section of each unit lists academic articles, book chapters or web-based sources that you can choose to read if you wish to further investigate a particular topic. Many of these readings can be accessed on the internet, but it is important to note that they will not be assessed in examination or assignments.

Although not mandatory, we think that you will enrich your study of this module by looking at such articles. Indeed, you are encouraged to choose your own additional reading on topics related to corporate governance. You can do this through searching the internet and by making use of the online academic journals through the Library resources on the Virtual Learning Environment (VLE).

## 4 Module Overview

### Unit 1 Elements and Objectives of Bank Regulation

- 1.1 Introduction
- 1.2 Bank Failures and Banking Crises
- 1.3 Is Bank Regulation Different from Regulating Non-Financial Firms?
- 1.4 Prudential Regulation for a Basic Bank
- 1.5 What is the Purpose of Prudential Regulation?
- 1.6 From the Simple Basic Model towards Actual, Complex Banks
- 1.7 The Global Financial Crisis and what regulators are left to do
- 1.8 Conclusion

### Unit 2 International Rules for Prudential Regulation

- 2.1 Introduction – Evolution of Coordinated International Rules
- 2.2 Basel I
- 2.3 Basel II
- 2.4 Basel II
- 2.5 How do Changes in Regulation Generate Costs and Benefits to the Specimen ?
- 2.6 Conclusion

### Unit 3 Financial Stability, Bank Structure and Shadow Banking

- 3.1 Introduction
- 3.2 Commercial Banking and Investment Banking – Joined or Separate?
- 3.3 Shadow Banking – Good for the Banking System or Too Shadowy?
- 3.4 Conclusion

### Unit 4 Macroprudential Regulation and Policy

- 4.1 Introduction: Motivation for Macroprudential Regulation (Macropru)
- 4.2 Macroprudential Policies: Why and How
- 4.3 Interactions with Other Policies and International Dimensions
- 4.4 Does it work? Empirical Studies of Macroprudential Policies

## 4.5 Conclusion

**Unit 5 Deposit insurance and Lender of Last Resort – Before and After the 2008 Crisis**

## 5.1 Introduction

## 5.2 Deposit Insurance

## 5.3 LOLR – Its Origins and Classic Character

## 5.4 The 2008 Crisis and New Role for Central Banks Operating as LOLR

## 5.5 LOLR as the New Monetary Policy

## 5.6 Conclusion

**Unit 6 Dealing with Bank Failure: ‘Too Big to Fail’ and New Resolution Regimes**

## 6.1 Introduction

## 6.2 What is Special About the Insolvency of Banks?

## 6.3 ‘Too Big to Fail’ and G-SIBs

## 6.4 Lessons of the 2008 Crisis: The Birth of Bail-in

## 6.5 Conclusion: Bank Resolution, Lessons from the Financial Crisis

**Unit 7 The Institutional Structure of Financial Regulation**

## 7.1 Introduction

## 7.2 Approaches to Institutional Structure for Financial Regulation

## 7.3 Why is Regulatory Structure Important?

## 7.4 Recent Trends in Regulatory Structure

## 7.5 Regulatory Structure and the Role of the Central Bank

## 7.6 The Fully Unified Approach to Financial Sector Supervision

## 7.7 Two Contrasting Models of Financial Regulation

## 7.8 The UK’s Financial Services Authority – Lessons from the 2008 Financial Crisis

## 7.9 Conclusion

**Unit 8 Issues in International Regulation and Supervision**

## 8.1 Offshore Financial Centres

## 8.2 Regulation, International Institutions, Standards and Codes

## 8.3 On the Political Economy and Ethics of Banking Regulation

## 8.4 Conclusion

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**5 Learning Outcomes**

When you have completed your study of this module, you will be able to:

- explain what is the target and what are the working mechanics of microprudential and macroprudential regulation of banks and other financial intermediaries
- evaluate the purpose and the effects of capital adequacy regulations and their evolution
- contrast crisis prevention measures, such as deposit insurance and Lender of Last Resort, with resolution procedures, such as bail-out and bail-in, especially for globally-operating institutions

- explain how and to which extent shadow banking and offshore financial centres change or outright prevent the working of banking regulation
- evaluate open questions and unresolved issues in international regulation and supervision after the 2008 Financial Crisis.