

# Contemporary Issues in Financial Markets

## Module 4, 2019

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### Course description

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The overall purpose of the course is to engage students into the discussion of current issues and challenges that global financial markets are facing in the aftermath of financial crisis. The course will touch on numerous public policy issues, many of which are politically controversial and most of which are likely to continue to be important for years to come. A goal of the course is to provide students with a framework within which these public policy issues can be addressed in a useful manner.

### Course requirements, grading, and attendance policies

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The course grade will be based on the following: participation in class, tests, regular homework assignments, and a final exam. Homework will be assigned every week. There is no textbook. Reading materials will be provided on mynes.

*Readings:* Students should read assigned materials *before* each class, including the first one.

*In-class Tests:* At the beginning of each lecture (except the very first one), there will be short 5-minute tests with a question about material of the previous lecture. A goal of these tests is to help students not to fall behind on the material and to keep track of attendance. Make sure that you come on time.

*Homework assignments:* Each week students have to read required material and submit a short write-up with their answers on the questions. Don't expect to find all answers in the readings. NOTE: Many readings represent official reports and documents, some of them are very long; as in real life, there is no need to read them line by line, rather those documents can be skimmed through but more important parts must be read carefully.

*Write-ups:* There will be three write-ups (no write-up for the last lecture). Write-ups should be succinct and self-contained. Long write-ups are not necessarily good write-ups. Good business writing makes points in a manner that respects the reader's time. Typically, the answers to questions will not be heavily mathematical, but mathematical intuition will often be required to address some of the questions. Write-ups should be uploaded onto mynes at the beginning of class, including the very first class. Students should be prepared to discuss and defend the ideas in their write-ups in class. For some questions, there is no "right" or "wrong" answer, in the sense that finance and economics professors themselves are likely to disagree about the answers to the questions. Students may talk to other students about the assigned questions, but each student should prepare a write-up individually, without looking at the write-ups of other students. Each student should list on the write-up the names of the other students with whom the student discussed the write-up.

*Class participation:* Class attendance and participation are required. We will discuss issues that cannot be found in textbooks. Each class several financial concepts or theories studied in other courses and related to our material will be discussed; it would be useful to review them before each lecture.

Final Exam: A final 60-minute exam is in-class and closed-book. One double-sided A4 cheat-sheet is allowed.

Grading: Grading will be based on case write-ups (30%), in-class tests (15%), and a final exam (55%). Class participation will be taken into account as well. Missing class is strongly discouraged. Write-ups are graded on a scale with the following interpretation: 0=missing, 1=okey, 2=good; 3=great. Tests are graded on a scale with the following interpretation: 0=missing, 1=okey, 2=good.

## **Methodology**

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Students are expected to read material before the class, submit write-ups on assigned questions, and participate in class discussions.

## **Academic integrity policy**

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Cheating, plagiarism, and any other violations of academic ethics at NES are not tolerated.

## **Course materials**

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The course will require reading of various papers, reports, and official documents. Some of the readings are very long; there is no need to read them entirely from the first page to the last page, those readings can be just skimmed through, but most relevant and important parts have to be read carefully.

“Required readings” marked with stars should be completed before class. Students should come to class prepared to discuss required readings. “Optional readings” not marked with stars are materials students may want to read before class or after class, but they are not required. They may be the subject of class discussion, but the discussion should presume that not all students have read them. The “bedtime readings” are completely optional and include books students may want to read in the future, after the course is finished. They are included for general interest. For each topic, the questions for write-ups are presented. I also included links for interesting video clips. I reserve the right to change the syllabus as the course progresses and some interesting events happen.

Students have to read papers on Abacus case and submit the first write-up onto [my.nes.ru](http://my.nes.ru) before the first lecture on Mach 6!

The schedule of classes follows.

## Course contents

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### I. Financial Crisis, Abacus Deal

- Abacus deal as an example of a structured product
- Causes of financial crisis: Different views
- European perspective on the crisis, the example of Germany

### II. Regulations after Financial Crisis, London Whale Case

- Dodd-Frank Act in the US, MiFID in Europe, Basel III
- Bank regulation, bank capital and liquidity, cleaning of banking industry
- London Whale case
- Stress testing, systemic risk

### III. Risk Management, Commodities Markets

- Current and future oil prices, how to interpret forward curves
- Hedging: Metallgesellschaft hedging debacle
- Price manipulations in commodities market
- Cash settlement and fixings
- Corners and squeezes: Silver crisis of 1981, VW squeeze in 2008
- Risk Management in Russia, barrier options

### IV. Past and Future Market Crashes

- Macro crashes and liquidity crashes
- Chinese crash in 2015
- Debt crises in Europe and US

## I. **Financial Crisis, Abacus Deal** (Sat, March 30; 10:00-13:00)

REQUIRED READING:

**SEC Abacus Complaint.  
Dodd-Frank Summary.**

**Darrell Duffie, “The ABACUS 2007 AC-1 Deal: Structure and Investment Incentives,” SLIDE PRESENTATION, Graduate School of Business, Stanford University April 27, 2010**  
**“Charting the Financial Crisis: U.S. Strategy and Outcomes”, September 2018, SLIDES**  
**Martin Hellwig, 2018, “Germany and the Financial Crisis 2007-2017”**

*THEORY: Mortgage backed securities, securitization, credit risk management.*

OPTIONAL READING:

Ben Bernanke, 2010, “Monetary policy and housing bubble”.  
FCIC report (full text)

OPTIONAL VIDEO: (Senate Hearings on Goldman Sachs Case)  
[www.c-span.org/video/?293196-3/investment-banks-financial-crisis-goldman-sachs-chair-ceo](http://www.c-span.org/video/?293196-3/investment-banks-financial-crisis-goldman-sachs-chair-ceo)  
[www.c-span.org/video/?293196-1/investment-banks-financial-crisis-directors](http://www.c-span.org/video/?293196-1/investment-banks-financial-crisis-directors)

OPTIONAL VIDEO: (Brookings, Responding to the Global Financial Crisis, 10 years later)  
<https://www.brookings.edu/events/day-1-responding-to-the-global-financial-crisis/>

Questions (2-3 pages):

1. What features of the Abacus transaction make it a synthetic CDO squared?
2. According to the SEC complaint, why did Goldman Sachs commit fraud? List arguments of SEC.
3. Does Goldman agree with SEC charges? List arguments of Goldman.
4. Why Goldman ultimately decided to pay fine and settle this case?
5. Based on the summaries of the FCIC report by the majority Democrats and the two summaries by the minority Republicans, who would tend to think that the Abacus transaction is a good symbol of the financial crisis, the Republicans or the Democrats? Why?
6. Why was there so much cross-border lending and investment by German banks and why were their losses so large?

## II. Regulations after Financial Crisis, London Whale Case. (Tue, April 16; 19:00-22:00)

### REQUIRED READING:

**Report for U.S. Senate, 2013, "JPMorgan Chase Whale Trades: A Case History of Derivatives, Risks, and Abuses"**

**Frame, Scott W., Gerardi Kristopher, and Paul S. Willen, "The failure of supervisory stress testing: OFHEO's risk-based capital model for Fannie Mae and Freddie Mac."**

**Дмитрий Тулин, 2009, История банка Глобек как зеркало проблем российского банковского надзора.**

*THEORY: Modigliani-Miller theorem, corporate finance*

### OPTIONAL READING:

Board of Governors of Federal Reserve System, Dodd-Frank Act Stress Test 2016: Supervisory stress test methodology and results, June 2016:

<https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160623a1.pdf>

Kyle, Albert S, "How to implement contingent capital." Working paper. 2014

Dodd-Frank Act (full text): [www.sec.gov/about/laws/wallstreetreform-cpa.pdf](http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf)

White paper "Basel III: An easy to understand summary"

### OPTIONAL VIDEO:

Senate Hearings on London Whale Case

[www.c-span.org/video/?306502-102/jpmorgan-chase-trading-loss-jamie-dimon-testimony](http://www.c-span.org/video/?306502-102/jpmorgan-chase-trading-loss-jamie-dimon-testimony)

Выступление Эльвиры Набиуллиной на XXV Международном Финансовом Конгрессе

<https://www.youtube.com/watch?v=w153NjW2w8Q>

Круглый стол по банковскому регулированию, РЭШ, октябрь 2018

<https://news.nes.ru/news/NES-Roundtable-bank-regulation/>

Парламентские слушания на тему: "Об основных направлениях развития финансового рынка Российской Федерации на период 2019-2021 годов, 21.01.2019,

[https://www.youtube.com/watch?v=auYxEOLl3gw&list=PLOTE86Zdvda-wL\\_28Yoqe9Cb\\_fQxEJtA4](https://www.youtube.com/watch?v=auYxEOLl3gw&list=PLOTE86Zdvda-wL_28Yoqe9Cb_fQxEJtA4)

### Questions for Write-Up #1 (2-3 pages):

1. According to JP Morgan employees, did JP Morgan plan to make money on its "whale trades"?
2. Is JP Morgan's situation more similar to the situation of AIG during financial crisis or the situation of Goldman Sachs in Abacus case?
3. Based on the summaries of the FCIC report by the majority Democrats and the two summaries by the minority Republicans, who would tend to think that the London Whale case is a good symbol of the financial crisis, the Republicans or the Democrats?
4. What do Frame, Kristopher and Willen think are the main benefits of implementing stress tests? What are potential issues?

5. What do you think about the cleaning up Russian banking system implemented recently by the Bank of Russia? What are main difficulties? What should be priorities?

### III. Risk Management, Commodities Markets (Tue, April 23; 19:00-22:00)

REQUIRED READING:

**Franklin Edwards, 1995, “Derivatives can be dangerous for your health: the case of Metallgesellschaft”**

**CFTC vs Parnon and Arcadia, 2011**

**Bank of England, Fair and Effective Markets Review, June 2013**

*THEORY: hedging, risks, forward curves, risk premium*

OPTIONAL READING:

Bhardwaj, Geetesh, Gary Gorton, and Geert Rouwenhorst, “Facts and fantasies about commodity futures ten years later”, working paper 2015

Baumeister, Christiane, and “The art and science of forecasting the real price of oil”, Bank of Canada Review, Spring 2014

Albert S. Kyle, Cash settlement, price manipulation, and the Modigliani-Miller Theorem, 2007.  
U.S. Senate Hearings, 2014, Wall Street Bank Involvement with Physical Commodities

Questions for Case Write-Up #3 (2-3 pages):

1. Why Metallgesellschaft lost money? Did Metallgesellschaft hedge or speculate?
2. How much corporates need to hedge?
3. Would you say that Sberbank’s barrier option were reasonable tools to structure hedges for Transneft and Mechel? What would you recommend to these companies? Are there any similarities between Sberbank’s barrier option strategies with carry trades, AIG’s strategies or Buffett’s strategies?
4. Should a company hedge, if hedging is expensive? For example, if oil is now in steep backwardation, should an oil company hedge its future revenue?
5. Why it may be difficult for risk managers to explain why hedging is useful to CEOs?
6. Based on Bank of England’s Review, what are common themes in recent misconduct cases in FICC markets?

## IV. Past and Future Crises (Tue, April 30; 19:00-22:00)

### REQUIRED READING:

**Kyle, Albert S. and Anna Obizhaeva, “Large bets and stock market crashes”. 2014.**

**Obizhaeva, A little note on Chinese market crash of 2015**

**Zheng Song and Wei Xiong, 2018, Risks in China’s financial system**

### OPTIONAL READING:

**Jiangze Bian, Zhiguo He, Kelly Shue, Hao Zhou, Leverage-induced fire sales and stock market crashes, 2018**

**Tugkan Tuzun, “Are leveraged and inverse ETFs the new portfolio insurers?”, 2014.**

**Krueger Report on Puerto Rico, 2015**

*Theories: liquidity, principles of financial stability, macro prudential regulation*

### OPTIONAL READING:

Earl Thompson and Jonathan Treussard, “The tulipmania: Fact or artifact?”  
[http://www.academia.edu/149695/\\_The\\_Tulipmania\\_Fact\\_or\\_Artifact\\_](http://www.academia.edu/149695/_The_Tulipmania_Fact_or_Artifact_)

### OPTIONAL VIDEO:

Pete Kyle on crashes. [https://www.youtube.com/watch?v=pnsOQOuP\\_Vs](https://www.youtube.com/watch?v=pnsOQOuP_Vs)

Questions to Think about (No Write-up is expected):

1. Do you agree that Greece for Europe is the same as Puerto Rico for USA? What are similarities and differences?
2. If you were asked to predict what the next crises will be in the world in 2019-2020 or 2019-2024, what would you say ?
3. What are the biggest risks for Russia? What can be done to mitigate these risks ?

## **Bedtime Reading**

Financial Crisis Inquiry Committee Report (FCIC Report)

Ben Bernanke “The courage to act”

Hank Paulson “On the Brink: Inside the race to stop the collapse of the global financial system”, 2010

Tim Geithner “Stress test: Reflection of financial crises”, 2015

Sheila Bair “Bull by the horns: Fighting to save Main Street from Wall Street and Wall Street from itself”, 2013

Anat Admati and Martin Hellwig “The Bankers’ New Clothes”, 2013

Daniel Yergin “The Prize: The epic quest for oil, money, and power”

Juan Zarate, “Treasury’s war: Unleashing of a New Era of Financial Warfare“, 2015

## **Reading on the History of Financial Economics**

Peter Bernstein “Capital ideas”

Perry Mehrling “Fischer Black and the Revolutionary Idea of Finance”

Fischer Black “Holes in Black-Scholes”, 1988, Risk

Fischer Black “How to Use the Holes in Black-Scholes”, JACF, 1989

Fischer Black “How We Came Up with Option Formula”, JPM, 1989

Mark Kritzman “An Interview with Nobel Laureate Robert C. Merton”, 2017

## **Useful websites:**

U.S.: Brookings Institute, [brookings.edu](http://brookings.edu)

Europe: Bruegel, [bruegel.org](http://bruegel.org)

Russia: EEG, [eeg.ru](http://eeg.ru); Kudrin’s website, [akudrin.ru](http://akudrin.ru); CSR [csr.ru](http://csr.ru)

Bill Longbrake’s letters : <https://www.rhsmith.umd.edu/centers-excellence/center-financial-policy/news-events/news/longbrake-letter>