

MACQUARIE UNIVERSITY



Division of Economic and Financial Studies

UNIT OUTLINE

2003

ECON335

THE ECONOMICS OF FINANCIAL INSTITUTIONS

- | | |
|------------------|--|
| <i>Contents:</i> | <ol style="list-style-type: none">1. Course Overview2. Enquiries3. Course timetable4. Assessment5. Lecture topics6. Text book7. Reading list8. Essay topic9. Essay Cover Sheet |
|------------------|--|

Dr Sean Turnell
Lecturer-in-charge

ECON 335: ECONOMICS OF FINANCIAL INSTITUTIONS

I. COURSE OVERVIEW

Banking and finance institutions today have evolved into complex organisms that play a centrally important role in the modern economy. The management of financial corporations is a highly specialised task with many unique aspects. And the success (or failure) of banks carries the potential for significant ramifications in the markets for goods, services and labour across the wider macroeconomy.

This course:

- outlines the structure of the Australian finance industry
- studies the evolution of the payments system and the issues it raises
- analyses the risks of banking and how to manage them effectively
- examines banking theory, especially performance and productivity
- examines the role financial institutions can play in a country's development
- puts these in the context of official supervision and surveillance.

The course is designed to equip those who will work in banking, securities or government.

II. ENQUIRIES

The teaching staff in ECON 335 are:

Sean Turnell	(C5C Rm 380; Tel: 9850 8493)	Weeks 1-2, 9-13
Kim Hawtrey	(C5C Rm 392; Tel: 9850-8504)	Weeks 3-8

If you have general enquiries about the course, contact the Lecturer-in-charge (Sean Turnell). For specific enquiries about course notes, lectures, etc., contact the relevant lecturer for each part of the course. If the lecturer is not immediately available, it is best to leave a message with your name and telephone number so that staff can contact you. Students can receive help with study skills, lecture content, essay resources, assessment, etc.

III. COURSE TIMETABLE

Students attend three classroom hours per week, comprising **lectures** using a mix of theory and practical applications, delivered in Second Semester in the following session:

Thursday 6-9 p.m., W5A T1

Students are expected to attend the full quota of lectures; all the material covered in class is examinable.

IV. ASSESSMENT

Essay (25%) All students are required to submit an essay (on the set topic – see p.12) by **9.00 pm Tuesday, 14 October, 2003**. The essay should be approximately 2500 words in length, neatly written or typed, using one side of the paper only, and properly annotated with supporting footnotes and bibliography. Standard academic presentation guidelines should be adhered to (if in doubt, consult a common essay-writing guide). Keep a dated, witnessed photocopy of your essay in case of misadventure. Late essays will be subject to penalty, and plagiarism will receive strict disciplinary measures. Essays submitted late may or may not be accepted, at the discretion of the lecturer-in-charge.

In grading the essay, students are judged on the understanding of the relevant theory and empirical work, clarity of exposition, and effort put in. The essay should be properly structured and divided into sections with appropriate headings. It should include a synopsis, footnotes and bibliography. Students are warned to guard against PLAGIARISM. All quotations and ideas must be properly acknowledged. A cover sheet for the essay is attached to this study guide and on the back of the cover sheet is a statement regarding plagiarism: the declaration regarding plagiarism following the statement is to be signed and the cover sheet, with all details completed, to be securely attached to your essay. Essays without completed plagiarism declarations will not be marked.

IMPORTANT: The essay should be submitted at the Economics Reference Room (ERIC) in the lodging box provided by 9.00 pm on the due date, using the cover sheet at the end of this handout, with declaration signed.

Exam (75%) The final examination will consist of essay-type questions.

V. LECTURE TOPICS: OVERVIEW

	Lecturer:
WEEK: 1. The Evolution and Rationale of Financial Institutions	Turnell
2. The Evolution and Structure of the Australian Financial System	Turnell
3. Payments System	Hawtrey
4. Risk Management I: Portfolio risk	Hawtrey
5. Risk Management II: Interest rate risk	Hawtrey
6. Risk Management III: Credit risk	Hawtrey

7. Risk Management IV: Liquidity & other risks	Hawtrey
8. Investment Banking	Hawtrey
9. Off-Balance Sheet Business	Turnell
10. Financial Market Consolidation/Change	Turnell
11. Supervision I: Central Banking	Turnell
12. Supervision II: Capital Adequacy and Regulation	Turnell
13. Financial Institutions and Economic Development	Turnell

VI. USEFUL REFERENCES

There is **no** set text-book for Econ 335. Students should consult the following list of useful references, other references as indicated in lectures and other sources.

(a) Australian

Saunders, A. and H. Lange (1996), *Financial Institutions Management: A Modern Perspective*, Sydney: Irwin.

Valentine, T, Ford, G. and Copp, R. (2003), *Financial Markets and Institutions in Australia*, Sydney: Pearson Education Australia.

McGrath, M. and C. Viney (2003), *Financial Institutions, Instruments and Markets*, 4th ed., Sydney: McGraw Hill.

Davis, K. and I. Harper, eds. (1991), *Risk Management in Financial Institutions*, Sydney: Allen & Unwin.

Felmingham, B. and W. Coleman (1995), *Money and Finance in the Australian Economy*, Irwin.

Hunt, B. and C. Terry (1993), *Financial Instruments and Markets*, Melbourne: Nelson.

Lewis, M.K. and R.H. Wallace, eds. (1997), *The Australian Financial System*, Melbourne: Longman Cheshire (2nd edition).

(b) International

Rose, P. (1999), *Commercial Bank Management*, McGraw-Hill.

Cornett, M. & A. Saunders (1999) *Fundamentals of Financial Institutions Management*, Boston: Irwin.

Koch, T.W. (1995), *Bank Management*, 3rd ed., Fort Worth: Dryden Press.

Sinkey, J.F. (1992), *Commercial Bank Financial Management*, 3rd ed., Macmillan.

Sinkey, J.F. (2002), *Commercial Bank Financial Management*, 5th ed., Macmillan.

Kolb, R.W. ed. (1992), *The Commercial Bank Management Reader*, Kolb.

Gardner, M.J. and D.L. Mills (1994), *Managing Financial Institutions: An Asset/Liability Approach*, 3rd ed., Fort Worth: Dryden Press.

Marshall, J.F. and M.E. Ellis (1994), *Investment Banking and Brokerage*, Kolb.

Roussakiss, E.N. ed. (1994), *Cases in Commercial Management*, Kolb.

Bessis, J. (1995), *Risk Management in Banking*, New York: J. Wiley & Sons.

VII. READING LIST BY LECTURE TOPIC

1 & 2. The Evolution and Rationale of Financial Institutions / The Evolution and Structure of the Australian Financial System

Role of financial intermediaries
Changing pattern of financial institutions
History of banking
Commercial banking in Australia

*Saunders, A. and H. Lange (1996), Chs. 1, 2 and 3.

*Valentine, T., Ford, G. and R. Copp (2003), Ch. 4.

*Allen, F. and Santomero, A. (1998), 'The theory of financial intermediation', *Journal of Banking and Finance*, vol.21, pp.1461-1485.

*Allen, F. and Santomero, A. (2001), 'What do financial intermediaries do?', *Journal of Banking and Finance*, vol.25, pp.271-294.

Australian Prudential Regulatory Authority Website, www.apra.gov.au.

Edey, M. and B. Gray (1996), "The Evolving Structure of the Australian Financial System", in M. Edey, ed. (1996), *The Future of the Financial System*, Sydney: Reserve Bank of Australia.

Financial System Inquiry (1997), *Financial System Inquiry Final Report*, Canberra: AGPS.
(The Wallis Report), Chs. 1 - 4, 14.

Galbraith, J.K. (1995), *Money: Whence it Came, Where it Went*, 2nd Edn., London, Penguin Books.

*McGrath, M. and C. Viney (2003), Chs. 1, 2, 3.

Reserve Bank of Australia Website, www.rba.gov.au.

*Scholtens, B. and van Wensveen, D. (2000), 'A critique on the theory of financial intermediation', *Journal of Banking and Finance*, vol.24, pp.1243-1251.

Sinkey, J.F. (2003), Ch.1.

3. The Payments System

Payments system design and efficiency
Payments risk
Technological innovation

Avram, K. & R. Love, (1997), The Australian Payments System: Real time gross settlement, *Economic Papers*, 16 (c), June, pp. 28-38

Australian Payments System Council (1997), *Annual Report* Sydney: APSC.

Bullock, M. & L. Ellis (1998), 'Some Features of the Australian Payments System', *Bulletin*, Reserve Bank, Sydney, December, pp. 1-9.

*Bank for International Settlements (1994), *Payment Systems in Australia*, Basle, July.

Lewis, M. and Wallace, R. (1997), Ch. 4.

Felmingham, B. and W. Coleman (1995), Ch. 16.

Harper, I. & N. Slizys (1996), 'Measuring Seignorage in Australia', *Economic Papers*, 15 (c), June, pp. 20-27.

Financial System Inquiry (1997), *Financial System Inquiry Final Report*, Canberra, AGPS.
(The Wallis Report), Ch. 2.

Gilbert, R.A. (1989), "Payments System Risk: What Is It and What Will Happen If We Try To Reduce It?", *FRB of St. Louis Review*, 71, Jan/Feb, 3-17.

Gloster, G. (1991), "Payments System Risks", in Davis, K. and I. Harper, eds. (1991), 123-33.

Hunt and Terry (1993), Chs.1, 2, 3.

Kolb (1992), Part VI.

Carew, E. (1999), 'Dealing, Settlement and Payments', Chapter 16 of *Fast Money 4*, Sydney: Allen & Unwin.

Hoenig, T. (1995), 'The Evolution of the Payments System: A US Perspective', *FRB Kansas City Economic Review*, 80(3), 1995(3).

Mackrell, N.C. (1996), "Cheques and the Payments System", *RBA Bulletin*, October, 26-31.

*Sinkey, J.F. (1992), Chs. 5, 8.

Gosling, P. (1999), *Changing Money*, London: Bowerdean Publishing, June.

4. Risk Management I: Portfolio Risk

Balance sheet of a commercial bank

Measuring portfolio risk

Stochastic selection model

Application to bank balance sheet management

Diversification benefits

*Saunders, A. and H. Lange (1996), Ch. 4, *AND* pp . 194-196.

Carmichael, J. and P. Davis (1991), "The Relevance of Portfolio Theory to Risk Management in Financial Institutions", in Davis, K. and I. Harper, eds. (1991), 75-92.

Felmingham, B. and W. Coleman (1995), Ch. 15.

Gardner, M.J. and D.L. Mills (1994), Chs. 1, 5, 18.

Koch, T.W. (1995), Chs. 16.

*Sinkey, J.F. (1992), Chs. 13, 15; (2003), Ch.11.

Tress, R. (1987), "Portfolio Analysis for Financial Institutions", Chap. 22 in Jüttner, D. J. and T. Valentine, eds. (1987).

Sy, W., "Active Management of Portfolio Risk", in Davis, K. and I. Harper, eds. (1991), 147-159.

Wall, L. and D. Peterson (1990), "The Effect of Continental Illinois' Failure on the Performance of Other Banks", *Journal of Monetary Economics*, 77-99.

Whitelaw, J. (1997), "Portfolio, Management: Theory and Application", in Gray, B. & C. Cassidy (eds), *Credit Risk in Banking*, Sydney: Reserve Bank.

5. **Risk Management II: Interest Rate Risk**

Asset/Liability management
Measuring position risk
Gap analysis
Duration analysis and immunisation

*Saunders, A. and H. Lange (1996), Chs. 5, 6, 7.

Felmingham, B. and W. Coleman (1995), Chs. 11, 13, 14, 18.

Gardner, M.J. and D.L. Mills (1994), Chs. 8-11, 18-19.

Hunt, B. and C. Terry (1993), Ch. 9.

Koch, T. W. (1995), Chs 8, 9, 19.

Kolb, R. W. (1992), Part V.

McGrath, M. and C. Viney (1997), Chs. 18, 19, 20.

*Sinkey, J. F. (1992), Chs. 12, 16; (2003), Ch.8.

Smith, P. and M. Benci (1991), "Measuring and managing interest rate risk", in Davis, K. and I. Harper, eds. (1991), 46-60.

Rousakkis, E. N. (1994), Case 21.

Beissis, (1995), Chs. 12-14.

6. **Risk Management III: Credit Risk**

Lender-borrower agency problems
Measuring credit risk
Qualitative credit assessment
Quantitative credit assessment

Thompson, G. (1998), 'Old fashioned credit risk,' *ASX Perspective*, 1st Quarter, pp. 4-6.

Gray, B. (1998), 'Credit risk in the Australian Banking Sector', *FRB of New York Economic*

Policy Review, 4(3) October, pp. 61-70.

Gray, B. & C. Cassidy (eds) (1997), *Credit Risk in Banking*, Proceedings of a Conference, Sydney: Reserve Bank, May.

*Saunders, A. and H. Lange (1996), Ch. 8.

Felmingham, B. and W. Coleman (1995), Ch. 18.

Houghton, K. and M. Smith (1991), "Loan Risk and the Anticipation of Corporate Distress: West Australian Evidence", in Davis, K. and I. Harper, eds. (1991), 61-74.

Gardner, M.J. and D.L. Mills (1994), Chs. 14, 15.

Bessis, J. (1995), Chs. 7-9.

Koch, T.W. (1995), Chs 20, 21, 22, 23, 24.

Kolb, R.W. (1992), Part III.

Cornett, M. & A. Saunders (1999), Chaps. 10-11.

Sinkey, J.F. (1992), Chs. 17, 18, 19, 20; (2003), Ch.10, 11.

Altman, E.J., R. Haldeman, & P. Narayanan (1977), 'Zeta Analysis, A New Model to Identify Bankruptcy of Corporations', *Journal of Banking and Finance*, 1 (1) pp. 29-54.

7. **Risk Management IV: Liquidity and Other Risks**

Measurement of bank liquidity

Liquidity management: assets and liabilities

Other banking risks: foreign exchange, operational, sovereign risks

*Saunders, A. and H. Lange (1996), Chs. 13, 20.

Felmingham, B. and W. Coleman (1995), Ch. 18.

Cornett, M. & A. Saunders (1999), Chap. 13.

Gardner, M.J. and D.L. Mills (1994), Ch. 13.

Koch, T.W. (1995), Chs 11, 15.

Sinkey, J.F. (1992), Ch. 14 (2003), Ch.13.

Bessis, J. (1995), Ch. 10.

8. Investment Banking

Merchant banking vs commercial banking
Mergers, acquisitions and LBOs
Financial engineering
Funding and advisory services

Lewis, M. & R. Wallace (1997), Chap. 8.

*Marshall, J.F. and M.E. Ellis (1994), Chs. 1-10.

Saunders, A. and H. Lange (1996), Ch. 2.

Cornett, M. & A. Saunders (1999), Chap. 5.

Gardner, M.J. and D.L. Mills (1994), Ch. 26.

Wallace, R.H. (1993), "The Business Financiers: Merchant Banks and Finance Companies",
in Lewis, M.K. and R.H. Wallace, eds. (1993), Ch. 6.

9. Off-Balance Sheet Business

McGrath and Viney (2003), pp.59-63.

Saunders, A. and H. Lange (1996), Ch. 9.

See also APRA website, www.apra.gov.au

10. Financial Market Consolidation/Change

Berger, A.N., Demsetz, R.S. and Strahan, P.E. (1999), 'The consolidation of the financial services industry: Causes, consequences, and implications for the future', *Journal of Banking and Finance*, vol.23, pp.135-194.

Cetorelli, N. (2001), 'Competition among banks: Good or bad?', *Economic Perspectives* (Federal Reserve Bank of Chicago), pp.38-49.

De Nicolo, G. and Kwast, M.L. (2002), 'Systemic risk and financial consolidation: Are they related?', *Journal of Banking and Finance*, vol.26, no.5 (May), pp. 861-880.

Hogan, W.P. (1999), 'The future of banking: A survey', *The Economic Record*, vol.75, no.231, pp.417-427.

Llewellyn, D.T. (1996), 'Banking in the 21st Century: The transformation of an industry', *The Future of the Financial System*, Reserve Bank of Australia 1996 Conference Volume (available at RBA website, www.rba.gov.au).

Prowse, S. (1996), 'Alternative models of financial system development', *The Future of the Financial System*, Reserve Bank of Australia 1996 Conference Volume (available at RBA website, www.rba.gov.au).

11. Supervision I: Central Banking

Fraser, B.W. (1994), 'Central bank independence: What does it mean?', *Reserve Bank of Australia Bulletin*, December 1994.

Latter, T. (1997), 'Causes and management of banking crises', *Bank of England Handbook on Central Banking No.12*, available at Bank of England website, www.bankofengland.co.uk

Turnell, S.R. (2000), *Establishing an East Timorese National Currency via a Currency Board*, Macquarie Economics Research Papers, no.2/2000.

See also 'Mark Bernkopf's Central Banking Resource Centre', <<http://patriot.net/~bernkopf/>>.

12. Supervision II: Capital Adequacy and Regulation

*Valentine, T., Ford, G. and R. Copp (2003), Ch.6.

* McGrath, M. and Viney, C. (2003), pp.63-83.

Australian Prudential Regulatory Authority (APRA), *Submission to the Basel Committee on Banking Supervision: A New Capital Adequacy Framework*, APRA website, www.apra.gov.au

Basle Committee on Banking Supervision (1987), *International Convergence of Capital Measurement and Capital Standards*, <www.bis.org/publ/bcbs04A.pdf>

Basle Committee on Banking Supervision 2001, *Overview of the New Basle Capital Adequacy Accord*, <www.bis.org/publ/bcbsca02.pdf>

Commonwealth of Australia (1997), *Financial System Inquiry, Final Report* (Wallis Report). This report is available on the website of the Australian Treasury, www.treasury.gov.au

Commonwealth of Australia (2002), *Options for Improving the Safety of Superannuation*, Draft Recommendations of the Superannuation Working Group, 4 March 2002. This report is available on the website of the Australian Treasury, www.treasury.gov.au

13. Financial Institutions and Economic Development

Todaro, M.P. (2000), *Economic Development* (Chapter 17), New York, Addison-Wesley.

De Soto, H. (2000), *The Mystery of Capital*, London, Bantam Press. A nice summary of De Soto's arguments (by De Soto himself) is published in the IMF's *Finance and Development* journal, available online at <<http://www.imf.org/external/pubs/ft/fandd/2001/03/desoto.htm>>.

Holden, P. and Propoenko, V. (2001), 'Financial development and poverty alleviation: Issues and policy implications for developing and transition countries', *IMF Working Paper*, October, WP/01/160 (This paper is available on the IMF website, www.imf.org).

World Bank (2002), *World Development Report 2002, Building Institutions for Markets*, World Bank, Washington D.C. (This report is available on the World Bank website, www.worldbank.org).

VIII. ESSAY TOPIC

What are some of the (domestic) causes and consequences of 'bank runs'. What policies should a central bank adopt once a systemic panic sets in? What are some of the devices that have been suggested to rehabilitate a banking system that has experienced such crises?

In your answer the following articles should provide an excellent starting point. These references are available in ERIC.

- Eichengreen, B. and Arteta, C. (2000), 'Banking crises in emerging markets: Presumptions and evidence', *Center for International and Development Economics Research Paper, University of California, Berkeley*, no.115. Online: <http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1007&context=iber/cider>
- Enoch, C. et. al. (2003), 'Indonesia's banking crisis: What happened and what did we learn', *Bulletin of Indonesian Economic Studies* 39:75-92.
- Frydl, E.J. and Quintyn, M. (2000), 'The benefits and costs of intervening in banking crises', *IMF Working Paper* no: WP/00/47. Online: <http://www.imf.org/external/pubs/ft/wp/2000/wp00147.pdf>
- Goldstein, M. and P. Turner. (1996), 'Banking crises in emerging economies: Origins and policy options', *BIS Economic Papers* 46 (1996). Online: <http://www.bis.org/publ/econ46.pdf>
- Lindgren, C., et al., (1999), 'Financial sector crisis and restructuring: Lessons from Asia', *IMF Occasional Paper*, no.188, International Monetary Fund. Online: <http://www.imf.org/external/pubs/ft/op/opfinsec/op188.pdf>

IX. ESSAY COVER PAGE: ECON335

(To be stapled to the front of your essay)

DIVISION OF ECONOMIC AND FINANCIAL STUDIES

UNIT: ECON335: THE ECONOMICS OF FINANCIAL INSTITUTIONS

DUE DATE: TUESDAY 14 OCTOBER 2003, 9.00PM

SUBMIT TO: LABELLED BOX IN ERIC

CONTRIBUTION TO FINAL ASSESSMENT: 25%

CHECKLIST:

1. Have you made a photocopy of your essay?
2. Have you included a synopsis and used section headings?
3. Have you stapled all pages together? Do not submit essay in a manilla or plastic folder.
4. Have you read, signed and attached the University statement against plagiarism (overleaf)? Plagiarism will be penalised.
5. Submission procedure is by hand, to the lecturer, in class.

NAME: _____ STUDENT NO.: _____
(Surname) (Initials)

ESSAY SHORT TITLE: _____

ASSESSMENT	Good	Fair	Poor
Synopsis			
Presentation			
Acknowledgments			
References			
Length			

MARKS DEDUCTED (Maximum of 5) _____ (Lateness; No Synopsis; No Bibliography; No Acknowledgments; Incorrect Referencing; Illegibility)

FINAL MARK (out of 25):

MARKER'S COMMENTS:

DEFINITION OF PLAGIARISM

Plagiarism involves using the work of another person and presenting it as one's own. Any of the following acts constitutes plagiarism **unless the source of each quotation or piece of borrowed material is clearly acknowledged:**

- (a) copying out part(s) of any document of audio-visual material (including computer-based material);
- (b) using or extracting another person's concepts, experimental results, or conclusions;
- (c) summarising another person's work;
- (d) in an assignment where there was collaborative preparatory work, submitting substantially the same final version of any material as another student.

Encouraging or assisting another person to commit plagiarism is a form of improper collusion and may attract the same penalties.

STATEMENT TO BE SIGNED BY STUDENT:

- 1. I have read the definition of plagiarism that appears above.
- 2. In my essay I have carefully acknowledged the source of any material which is not my own work.
- 3. I am aware that the penalties for plagiarism can be very severe.

.....
(signature)

.....
(name)

.....
(student number)

THIS PAGE MUST BE COMPLETED AND ATTACHED TO THE ESSAY