MACQUARIE UNIVERSITY | FACULTY OF BUSINESS AND ECONOMICS

ECON 335

The Economics of Financial Institutions

Semester 2, 2009

UNIT OUTLINE

Contents:

1. Course Overview
2. Enquiries
3. Course timetable
4. Assessment
5. Lecture topics
6. Text book
7. Reading list
8. In-Class Essay

Assoc. Professor Sean Turnell
Lecturer-in-charge

ECON 335: THE ECONOMICS OF FINANCIAL INSTITUTIONS

I. COURSE OVERVIEW

Banking and financial institutions have evolved into complex organisms that play a critical role in the modern economy. Indeed, we will argue throughout this course that few institutions matter as much as those in the financial sector – a fact that recent events in global financial markets has demonstrated only too well!

There are many ways in which the importance of financial institutions is apparent – but let us start by taking matters back to fundamentals in asserting that financial institutions play a critical role in a country's economic growth and development. Such an idea has been around since the times of Adam Smith, but it is only relatively recently that a coherent narrative has emerged as to why this might be so. We now recognize numerous ways in which financial institutions promote growth:

- Financial institutions mobilise a country's savings (its surplus above subsistence), and channel those savings into their most productive uses.
- Financial institutions create the media of exchange through which we conduct economic activity beyond simple barter. This allows specialisation – the very source of the 'wealth of nations' identified by Smith in 1776.
- Financial institutions create credit. Credit permits economic expansion in response to developments in the 'real' economy (technical progress) which might otherwise be stymied by a barter or a purely commodity monetary system.
- Financial institutions aggregate funds for investment in amounts larger than that which would be allowed by the savings of single individuals. This allows greater economies of scale, but it also reduces the risk of investment to particular individuals, and thereby encourages innovation.
- Financial institutions, by providing a safe vehicle for savings and by advancing personal credit, allow individuals to 'smooth' consumption and better insure themselves against unexpected events.
- Finally (though this list is far from exhaustive), and so long as they are not distorted through inappropriate government intervention, the 'prices' determined by financial institutions (such as interest rates) act as critical 'signals' conveying information – to policy makers, to investors, to everyone.

Of course, the management of financial institutions is a highly specialised task with many singular aspects. Regarding the latter, it is important to recall that (unlike most other enterprises) financial institutions create products that are almost wholly intangible. Because of this they are uniquely dependent upon trust, and those other pillars of civilisation that we take for granted except when they are absent. It is no coincidence that countries with sound financial institutions are those countries possessing the attributes otherwise necessary for a well-functioning economy and society. Finally, the success (or failure) of financial institutions carries the potential for significant ramifications in the markets for goods, services and labour across the wider macroeconomy.

In Econ 335 we will:

- outline the <u>structure</u> of the Australian and global financial sectors
- analyse the <u>risks</u> of banking and how to manage them effectively

- examine financial intermediation theory
- examine the rise of the funds management industry
- examine the role financial institutions can play in economic development
- examine developments at the cutting-edge of financial institutions practice
- put all of these in the context of official supervision and surveillance.

The course is designed to equip those who will work in banking, securities or government – and, indeed, anyone who wishes to understand the modern world.

II. ENQUIRIES

Sean Turnell (E4A Rm 426; Tel: 9850 8493, sean.turnell@mq.edu.au)

If you have *any* enquiries about the course please contact me via any of the above.

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:

Friday 5 – 8 p.m., X5B T1

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

Note that, because of 'Conception Day' (Friday, 19 September), there is **no** lecture in Week 7.

IV. ASSESSMENT

Mid-Term Exam (40%)

On **Friday 9 October (Week 8)** all students are required to sit for a mid-term multiple choice and essay exam.

The multiple choice component of the exam (worth 20% of the final marks) will consist of 20 questions relating to the material covered up to the end of the previous week. Normal exam conditions will apply.

The essay component of the exam (also worth 20% of the final exam) will comprise one question, and will likewise be drawn from material covered thus far in the course.

Final Exam (60%)

V. LECTURE TOPICS: OVERVIEW

Topic:

1. Introduction – Functions and Forms of Banking, Regulatory Overview.
2. The Theoretical Rationale of Financial Institutions.
3. The Management of Financial Institutions I: Liabilities Management.
4. The Management of Financial Institutions II: Credit Evaluation.
5. The Management of Financial Institutions III: Commercial, Real Estate and Consumer Lending.
6. The Management of Financial Institutions IV: Securities Portfolio Management.
7. The Management of Financial Institutions V: Interest Rate Risk Management.
8. The Management of Financial Institutions VI: Off Balance Sheet Activities.
9. The Management of Financial Institutions VII: Liquidity and Capital Management.
10. Wider Financial Services: Insurance, Wealth Management.
11. Financial Market Consolidation.
12. Financial Institutions and Economic Development.
13. Moneylenders, Informal, and Microfinance Institutions.

VI. USEFUL REFERENCES

There is **no** set textbook for Econ 335. However, the following are useful:

(a) Australian

Gup, B.E., Avram, K. *et.al.*, (2007) *Commercial Banking: The Management of Risk,* Melbourne: John Wiley & Sons Australia.

Hogan, W. *et al,* (2004), *Management of Financial Institutions,* 2nd edn, Melbourne: John Wiley & Sons.

Hunt, B. and Terry, C. (2005), *Financial Institutions and Markets,* 4th edn, Melbourne: Thomson.

Saunders, A. and Lange, H. (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.

(b) International

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

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

VII. READING LIST BY LECTURE TOPIC

1 - 2. Introduction /Functions and Forms of Banking/The Theoretical Rationale of Financial Institutions/Regulatory Overview

Gup, *et. al* (2007), Ch.1, 2.

Hogan, *et. al* (2004), Ch.1.

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.

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.

3. The Management of Financial Institutions I: Liabilities Management

Gup, *et.al* (2007), Chs. 13, 14.
Hogan, *et. al.*(2004), Ch. 5.

4. The Management of Financial Institutions II: Credit Evaluation

Gup, *et.al* (2007), Ch.8.
Hogan, *et. al.*(2004), Chs. 9, 10.

5. The Management of Financial Institutions III: Commercial, Real Estate and Consumer Lending

Gup, *et.al* (2007), Chs. 9, 10.
Hogan, *et. al.*(2004), Chs. 11, 12.

6. The Management of Financial Institutions V: Securities Portfolio Management

Gup, *et.al* (2007), Ch.7.
Hogan, *et. al.*(2004), Ch.7.

7. The Management of Financial Institutions IV: Interest Rate Risk Management

Gup, *et. al* (2007), Ch.5.
Hogan, *et. al* (2004), Ch.4.

8. The Management of Financial Institutions VI: Off-Balance Sheet Activities

Gup, *et.al* (2007), Chs. 13, 14.
Hogan, *et. al.*(2004), Ch. 5.

9. The management of Financial Institutions VII: Liquidity and Capital Management. Basel, Where to Now?

Gup, *et.al* (2007), Chs. 11, 12.
Hogan, *et. al.*(2004), Chs. 6, 8.

10. Wider Financial Services - Funds Management and Insurance

Gup, *et. al* (2007), Ch.15, 16.

Hunt, B. and Terry, C. (2005), Ch. 5.

APRA website, www.apra.gov.au

11. Financial Market Consolidation

Gup, *et. al* (2007), Chs 3, 4.

Hogan, *et. al.* (2004), Ch.1.

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.

12. Financial Institutions and Economic Development

Todaro, M.P. (2003), *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/)1/160 (This paper is available on the IMF website, www.imf.org).

Turnell, S.R. 2009, *Fiery Dragons: Banks, Moneylenders and Microfinance in Burma,* Copenhagen: Nordic Institute of Asian Studies.

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).

13. Moneylenders, Informal and Microfinance Institutions

Sengupta, R. and Aubuchon, C. 2008, 'The Microfinance revolution: An Overview', *Federal Reserve Bank of St. Louis Review,* January/February, pp.9-30. This is available online at: http://research.stlouisfed.org/publications/review/

Turnell, S.R. 2009, *Fiery Dragons: Banks, Moneylenders and Microfinance in Burma,* Copenhagen: Nordic Institute of Asian Studies.

Relevant sections at:

http://econ.mq.edu.au/research/2005/chettiar.pdf
http://econ.mq.edu.au/research/2005/co-opTurnell.pdf
http://www.econ.mq.edu.au/Econ_docs/bew/1BEW2005.pdf

Muhammad Yunus's Nobel Prize acceptance speech, see:
http://nobelpeaceprize.org/eng_lect_2006b.html