



## ECON 335

# The Economics of Financial Institutions

Semester 2, 2010

## UNIT OUTLINE

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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 structure of the Australian and global financial sectors
- analyse the risks 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](mailto: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., E7B Mason Theatre

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, 17 September), there is **no** lecture in Week 7.

If you are ever in doubt about timetabling and class times and places, see the University’s website:

<http://www.timetables.mq.edu.au/>

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

It is my expectation that the lectures of Econ 335 will be recorded on the University’s i-Lecture facility. This can be found at:

<http://learn.mq.edu.au>

The ‘Blackboard’ facility at this same site will also be the main vehicle through which unit communications will be made, and via which students can communicate with each other.

#### **IV. ASSESSMENT**

##### **Within Semester Exam (40%)**

On **Friday 3 September (Week 5)** all students are required to sit for a within-semester exam.

The exam will consist of short answer questions that relate to Topics 1 and 2 of the course, as well as selected readings. Details of these readings are outlined in Section VIII of this Study Guide. Normal exam conditions will apply.

##### **Final Exam (60%)**

The Final Exam will consist of essay and multiple choice questions.

#### **V. LECTURE TOPICS: OVERVIEW**

##### **1. Introduction – Functions and Forms of Banking, Regulatory Overview.**

##### **2. The Theoretical Rationale of Financial Institutions.**

*Case Study Extra: The Pillars of Australian Banking*

##### **3. The Management of Financial Institutions I: Liabilities Management.**

*Case Study Extra: The Global Network Banks, HSBC, Standard Chartered, Citigroup*

##### **4. The Management of Financial Institutions II: Credit Evaluation.**

*Case Study Extra: Banking on the USA*

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

*Case Study Extra: Banking European Style*

##### **6. The Management of Financial Institutions IV: Securities Portfolio Management.**

*Case Study Extra: Emerging Market Banks*

##### **7. The Management of Financial Institutions V: Interest Rate Risk Management.**

*Case Study Extra: Burma's Broken Banks*

##### **8. The Management of Financial Institutions VII: Liquidity Management.**

##### **9. The Management of Financial Institutions VIII: Capital Management.**

##### **10. Wider Financial Services: Insurance, Wealth Management.**

##### **11. Financial Institutions and Economic Development.**

##### **12. Moneylenders, Informal, and Microfinance Institutions.**

## VI. USEFUL REFERENCES

There is no set textbook for Econ 335. However, the following *may* be 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*, 2<sup>nd</sup> edn, Melbourne: John Wiley & Sons.

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

Saunders, A. and Lange, H. (2007), *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

A. Saunders and Cornett, M.M. (2007) *Fundamentals of Financial Institutions Management*, 6<sup>th</sup> Edn, Boston: Irwin.

Sinkey, J.F. (2002), *Commercial Bank Financial Management*, 5<sup>th</sup> 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](http://www.apra.gov.au).

Reserve Bank of Australia Website, [www.rba.gov.au](http://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 VII: Liquidity Management**

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

### **9. The Management of Financial Institutions VIII: Capital Management**

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](http://www.apra.gov.au)

### **11. 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](http://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](http://www.worldbank.org)).

## **12. 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>

Muhammad Yunus's Nobel Prize acceptance speech, see:

[http://nobelpeaceprize.org/eng\\_lect\\_2006b.html](http://nobelpeaceprize.org/eng_lect_2006b.html)

## **VIII. Within Semester Exam**

As noted above, in Week 5 (Friday 3 September) students are required to sit for a Within Semester Exam. The exam will take place at the usual lecture venue (Mason Theatre), and will commence at approximately 6.10 pm. The exam will consist of a number of short answer questions. The answers to these are to be written directly onto the question sheet, in the spaces provided.

The Within Semester Exam will be based on Topics 1 and 2 of the course, **plus** the readings below:

1. Battelino, R. 2010, 'Some comments on bank funding', *Reserve Bank of Australia, Bulletin*, March Quarter 2010, pp.71-76, available online at: <http://www.rba.gov.au/speeches/2009/sp-dg-161209.html> Please note - a PDF version of this is likewise available at the Bulletin site.

2. Schwartz, C. 2010, 'The Australian Government guarantee scheme', *Reserve Bank of Australia, Bulletin*, March Quarter 2010, pp.19-26, available online at: <http://www.rba.gov.au/publications/bulletin/2010/mar/4.html>  
Please note - a PDF version of this is likewise available at the Bulletin site.
3. Stevens, G. 2009, 'Developments in financial regulation', *Reserve Bank of Australia, Bulletin*, December Quarter 2009, pp.28-34, available online at: <http://www.rba.gov.au/speeches/2009/sp-gov-081209.html> Please note - a PDF version of this is likewise available at the Bulletin site.
4. Calomaris, C.W. 2010, 'Banking crises yesterday and today', *Financial History Review*, vo.17, no.1, pp.3-12.

Normal exam conditions will apply.

## **IX. Special Consideration**

The University is committed to equity and fairness in all aspects of its learning and teaching. In stating this commitment, the University recognises that there may be circumstances where a student is prevented by unavoidable disruption from performing in accordance with their ability. A special consideration policy exists to support students who experience serious and unavoidable disruption such that they do not reach their usual demonstrated performance level. The policy is available at:

[http://www.mq.edu.au/policy/docs/special\\_consideration/procedure.html](http://www.mq.edu.au/policy/docs/special_consideration/procedure.html)

## **X. Student Support Services**

Macquarie University provides a range of Academic Student Support Services. Details of these services can be accessed at <http://www.student.mq.edu.au>.