



## ECON 335

# The Economics of Financial Institutions

Semester 1, 2011

## UNIT OUTLINE

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Lecturer-in-charge

# ECON 335: *THE ECONOMICS OF FINANCIAL INSTITUTIONS*

Students should read this unit outline *carefully* at the start of semester. It contains important information about the unit. If anything in it is unclear, please consult one of the teaching staff in the unit.

## 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 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), the 'prices' determined by financial institutions (such as interest rates) can 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 First Semester in the following sessions:

|         |                       |
|---------|-----------------------|
| Day     | Friday, 2 – 5 p.m.    |
| Evening | Wednesday, 6 – 9 p.m. |

Students are expected to attend the full quota of lectures; all the material covered in class is examinable. Of course, you only have to attend one of these streams.

Note that 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/>

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%)**

In lectures in Week 8 all students are required to sit for a within-semester exam. The exam will consist of true/false, multiple choice and short answer questions on non-banking financial institutions (including insurance and superannuation) and international banking. Details of the exam are outlined in Section VIII below. 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.**



Indic Capital: From the Temple of Khajuraho, India.

## 10. Financial Institutions and Economic Development.



## 11. Moneylenders, Informal, and Microfinance Institutions.



## VI. USEFUL REFERENCES

The textbook for this course (as it is for the 'sister unit', Econ 350, *Money and Finance*) is Kidwell, D. *et al.* 2011, *Financial Markets, Institutions and Money*, John Wiley & Sons, Milton, Qld.

Other useful books include:

### (a) Australian

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

Saunders, A. and Lange, H. (2007), *Financial Institutions Management: A Modern Perspective*, Sydney: Irwin.

Valentine, T. *et al.* 2011, *Financial Markets and Institutions in Australia*, Pearson, Frenchs Forest, NSW

Hunt, B. and Terry, C. 2008, *Financial Institutions and Markets*, 5<sup>th</sup> edn, Thomson

### (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**

Kidwell, *et. al.* (2011), Ch.1, 13.

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

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**

Kidwell, *et. al.* (2011), Ch.13.

Gup, *et.al* (2007), Chs. 13, 14.

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

Kidwell, *et. al.* (2011), Ch.13.

Gup, *et.al* (2007), Ch.8.

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

Kidwell, *et. al.* (2011), Ch.13.

Gup, *et.al* (2007), Chs. 9, 10.

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

Kidwell, *et. al.* (2011), Ch.5, 13.

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

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

Kidwell, *et. al.* (2011), Ch.5, 13.

Gup, *et. al* (2007), Ch.5.

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

Kidwell, *et. al.* (2011), Ch.7,12, 13.  
Gup, *et.al* (2007), Chs. 11, 12.

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

Kidwell, *et. al.* (2011), Ch. 2, 12, 13.  
Gup, *et.al* (2007), Chs. 11, 12.

## **10. 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/01/160 (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)).

## **11. 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)

For some excellent material on the current controversies surrounding microfinance (much of it coming from India), as well as a superb site more generally, see the World Bank's 'Microfinance Gateway' at: [www.cgap.org](http://www.cgap.org)

## VIII. Within Semester Exam

As noted above, in Week 8 students are required to sit for a Within Semester Exam. The exam will take place at the usual lecture venues, and at the usual start times.

The mid-semester exam will test your understanding of the nature and role of non-bank financial institutions (including insurance and superannuation), as well as international banking. It will be based on Chapters 14, 15 and 16 of our textbook (Kidwell *et al* 2011). It is critically important that you access these chapters, read them thoroughly, and understand them. Don't forget – the mid-semester exam is worth 40% of your final assessment. The exam will consist of true/false, multiple choice and short-answer questions, which you will write directly onto the question sheet that will be provided.

Normal exam conditions will apply, as will various measures to ensure exam integrity and security. Accordingly, you must attend the lecture stream in which you are formally enrolled, and you are required to bring your University ID Card.

Failure to attend the mid-semester exam will result in a mark of **zero** for this assessment component. Students who experience *serious misadventure* and are unable to attend the exam should contact me (Sean Turnell) as soon as is reasonable, and provide full documentation explaining their non-attendance. As a matter of **justice** to all students, flimsy excuses will be rejected outright. If the documented evidence is accepted, the final exam mark will be converted to a higher percentage of the total marks.

## 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>.

## **XI. Learning Outcomes**

As it should be, content is king in Econ 335. And content is all contained in the above. Knowing the content is the *sine qua non*<sup>1</sup> for success in this unit.

That said, there are some 'generic' learning outcomes that should come from successfully completing Econ 335 (as it should from all courses at Macquarie):

- To be open to new (and *old!*) ways of thinking and appreciate the importance of intellectual curiosity and reflection as the foundation for continuous learning.
- To be able to identify, and call out, ideas that are merely ephemeral, fashionable, politically-correct or mindlessly conform to the conventional wisdom.
- To identify, define and analyse problems and recommend creative solutions within real-world constraints.
- To demonstrate a capacity to work independently including the ability to plan and achieve goals.
- To critically evaluate underlying theories, concepts, assumptions, limitations and arguments in disciplinary and cross-disciplinary fields of study.
- To be intellectually ready to participate in public policy discussions arising in social, business and policy environments;
- To manage, analyse, evaluate and use information efficiently and effectively.

## **XII. IT Policy**

Access to all student computing facilities within the Faculty of Business and Economics is restricted to authorised coursework for approved units. Student ID cards must be displayed in the locations provided at all times.

Students are expected to act responsibly when utilising University IT facilities. The following regulations apply to the use of computing facilities and online services:

- Accessing inappropriate web sites or downloading inappropriate material is not permitted. Material that is not related to coursework for approved unit is deemed inappropriate.
- Downloading copyright material without permission from the copyright owner is illegal, and strictly prohibited. Students detected undertaking such activities will face disciplinary action, which may result in criminal proceedings.

Non-compliance with these conditions may result in disciplinary action without further notice.

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<sup>1</sup> Latin, and roughly, 'without which there is nothing'.

Students must use their Macquarie University email addresses to communicate with staff as it is University policy that the University issued email account is used for official University communication.