

PAPER OUTLINE

Paper Title: **Special Topic: Financial Intermediation**

Paper Code: **FINA580-09B (HAM)**

School: **Waikato Management School**

Department: **Finance**

Location: **Main Campus, Hillcrest Road, Hamilton**

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TIMETABLE DETAILS:

This course has been set up in Moodle. The required resources are stored there.

Lectures

Lecture Time	Room
Mon 12pm – 2pm	TA.2.06

Group Information

PURPOSE STATEMENT

This course is structured into the following segments. In segment 1, we review the nature of banking and the justification for banks' existence in the theory of intermediation (lecture topics T-1 to T-3). In segment 2, we focus on risks in banking, namely credit, market, interest rate and liquidity risks, as well as particular issues related to securitization of bank assets (lecture topics T-4 to T-6). In segment 3, in the light of these risks, we then address measures for safeguarding the integrity of the banking system through preventive regulation and supervision but also banking crises management (lecture topics T-7 to T-8). A final segment 4 looks at future trends in banking followed by a review of two types of non-depository intermediaries, namely insurance companies and (if time permits) mutual funds (lecture topics T-9 to T-10)

LEARNING OUTCOMES

- 1 : Justify the existence and explain the activity of banks.
- 2 : Demonstrate comprehension of the nature of bank risks together with the means for controlling them by bank managers and/or regulators.
- 3 : Appreciate real world complexities of evaluating financial institutions.

TOPICS

• T-1 Introduction, warm-up

a. Overview financial intermediaries

*Greenbaum & Thakor (2007, chapter 2); slides Greenbaum & Thakor with chapter 2
Matthews & Thompson (2008, chapter 4: banking typology)*

b. Basic concepts

The theory of financial intermediation is based on concepts mainly developed in financial economics. This section follows Greenbaum & Thakor (2007, chapter 1), Matthews & Thompson (2008, section 7.5, p. 102-107)

We will also have a first look at the structure of bank financial statements

• T-2 Theories of financial intermediation

This section tries to answer the question of 'Why do financial intermediaries exist?' It reviews literature on traditional financial intermediation theory which generally builds on the notion that intermediaries serve to reduce transaction costs and informational asymmetries. In general, it covers selected topics from Matthews & Thompson (2008, Chapters 2&3, p. 21-49) and Freixas & Rochet (1997, chapter 2, p. 18-50)

• T-3 The theory of the banking firm

a. Fractional reserve banking, money multiplier (fixed coefficient model):

*Greenbaum & Thakor (2007, chapter 3, p. 91-107); PPT slides Greenbaum & Thakor with chapter 3
Matthews & Thompson (2008, section 6.2, p. 78-80)
Frost (2004, p. 50-54)*

b. Bank competition models (incl. Monti-Klein, Cournot imperfect competition model)

*Matthews & Thompson (2008, chapter 6, sections 6.3-6.5, p. 80-90)
Freixas & Rochet (1997, section 3.2., p.57-61)*

• T-4 Risks

This section gives an overview of the different sources of risk in financial intermediation, namely credit risk, interest rate /market risk and liquidity risk.

a. Credit risk

Default or credit risk represents the core risk for banks and credit losses, or more generally, asset quality problems, have repeatedly been identified as a key trigger of bank failures, e.g. Graham and Horner (1988), Caprio and Klingebiel (1996). The discussion includes economic issues relating to the banks' traditional on-balance business, e.g. the lender-borrower relationship. A framework for the credit analysis of borrowers is presented and applied in a case study. Finally, the issue of credit rationing will be covered.

Resources: Greenbaum & Thakor (2007, selected topics from chapters 5 & 6), Moody's default statistics, selected chapters from Frost (2004) and Grier (2007). Credit rationing as covered in Matthews & Thompson (2008, chapter 8, p. 115-129)

b. Non-credit risks

The major risks discussed here are interest rate and liquidity risks. The value of assets and liabilities is subject to variations of market prices, namely the level and structure of interest rates. Liquidity risk or withdrawal risk at banks is the risk that depositors unexpectedly withdraw their deposits with the bank unable to realize the full value of a corresponding amount of its assets to satisfy this demand.

Resources: Greenbaum & Thakor (2007, selected topics from chapter 4)

• **T-5 Risk management**

a. This section discusses methods and systems to manage and/or mitigate risks in banking. Risk model implementations from various subject areas (mainly asset liability management and credit risk management) are reviewed here. We also touch on issues related to credit loss provisioning.

Resources: Matthews & Thompson (2008, selected topics in chapter 13, p. 209-241), Greenbaum & Thakor (2007, chapter 13)

• **T-6 Securitization**

Securitization are comparably recent innovation in the financial industry which involves the pooling of a wide range of financial assets and repackaging them into so-called asset-back securities. Text book resources are Matthews & Thompson (2008, chapter 9) and Greenbaum & Thakor (2007, chapter 9) together with case studies of selected asset-backed securities.

This section will also review selected off-balance sheet banking products in general (Greenbaum & Thakor, 2007, selected topics in chapter 8).

• **T-7 Banking regulation and supervision**

This section firstly reviews literature regarding ideal levels of banking regulation and supervision. It then looks at international trends in this area, in particular at the features of the new Basel II capital accord. We also probe issues related to deposit insurance schemes.

Resources: Matthews & Thompson (2008, chapter 12), Greenbaum & Thakor (2007, selected topics in chapter 11,12)

• **T-8 Banking crises and system stability**

This part of the course takes the perspective of a prudential regulator of the banking system. Issues related to maintaining the stability of the financial system in times of economic stress and bank failure management are discussed here.

• **T-9 The future of banking**

This section looks at trends and new developments in banking. A series of student presentations will cover topics like person-to-person (P2P) lending, microfinance, Islamic banking.

Textbook: Matthews & Thompson (2008, Chapter 1: Trends in Domestic and International Banking), Llewellyn (1996), Greenbaum & Thakor (2007, chapter 16)

• **T-10 Selected non-depository intermediaries**

a. Insurance companies

This section deals with insurance companies as a particular type of financial intermediary. We look at the characteristics of the life and non-life insurance business. Selected topics related to these firms will be covered, namely asset and liability management, solvency requirements and embedded value concept.





b. *Mutual funds*

Over the recent years, funds intermediated by mutual funds have grown more rapidly than assets with other financial intermediaries. As an invited guest speaker, an experienced asset manager from a well-known financial institution will present his perspective and discuss current and future issues facing the funds industry.



ASSESSMENT

Internal Assessment/Final Examination 3:2

Internally Assessed Components

Component Details			Submission Details		
Component	Due Date	Weighting	Compulsory	Where	How
 Bank Analysis Project	9/09/2009	60.00%		Online	Web Submit
 Bank Analysis Project (Report)	9/09/2009	0.00%		Online	Web Submit
 Student class presentation	16/10/2009	40.00%		Online	Web Submit
 Student Class Presentation (Summary Report)	16/10/2009	0.00%		Online	Web Submit
Total		100%			
Notes <ul style="list-style-type: none"> • The above Internally assessed components make up 60.00% of the total assessment. • The Final Examination makes up the remaining 40.00% • You are required to complete the Assessments marked as "Compulsory". YOU MUST do the Compulsory Assessment otherwise you will not pass the Paper. 					

Examination

Examination	Starts	Ends	Weighting	Compulsory	Where	How
 Exam	Not Available		40.00%		at Exam	Printed

Assignment Details

Bank Analysis Project (Due Date: Wednesday, 9 September 2009)

Students are required to select a bank and conduct a thorough analysis of this institution. Requirements include the collection of 3-years of historical data of the bank into a spreadsheet template provided as well as a report which presents the results of the whole analysis. Detailed requirements are laid out in separate handout. Use this component to submit your completed spreadsheet template.

Bank Analysis Project (Report) (Due Date: Wednesday, 9 September 2009)

Use this web component to submit your bank analysis report (MS Word format). Weighting for this report for the total mark of project is indicated in detailed description of project.

Student class presentation (Due Date: Friday, 16 October 2009)

Students are asked to select topics in financial intermediation (either self-defined or chosen from a pre-defined list) and prepare a class presentation. These presentations will be embedded in regular lecture sessions (if possible) and there is a dedicated presentations session towards the end of the course. Requirements include a brief summary report of the findings. Detailed

requirements in a separate handout. **Student Class Presentation (Summary Report)** (Due Date: Friday, 16 October 2009)

Use this web component to submit your summary report of your class presentation (MS Word format). Weighting of report for final grade as indicated in detailed description of class presentation requirements.

Examination (Date: Unavailable)

The 2 hour final exam will consist of three sections. Section 1 will test your basic understanding of concepts in the area of financial intermediation. Section 2 is more analytical and requires some calculations in the framework of a model we have discussed in class. Finally, the third part is interpretative and will include short answer and essay type questions. More advice on how to best prepare for the exam will be provided closer to the time.

RESOURCES

Required

Recommended

Matthews, K., & Thompson, J. L. (2008). *The economics of banking* (2nd ed.). Chichester, England ; Hoboken, NJ: Wiley.

Greenbaum, S. I., & Thakor, A. V. (2007). *Contemporary financial intermediation* (2nd ed.). Amsterdam ; Boston: Elsevier Academic Press.

Other Resources

Bikker, J., & Wesseling, S. (2003). Intermediation, integration and internationalisation: a survey on banking in Europe, *DNB Occasional Studies* (Vol. 1). Amsterdam: De Nederlandsche Bank.

Caprio, G., & Klingebiel, D. (1996). Bank insolvencies : cross-country experience. *Worldbank Working Paper WPS1620*.

Freixas, X., & Rochet, J.-C. (1997). *Microeconomics of banking*. Cambridge, Massachusetts: MIT Press.

Frost, S. M. (2004). *A bank analyst's handbook : money, risk, and conjuring tricks*. Hoboken, NJ: John Wiley & Sons.

Graham, F., & Horner, J. (1988, May). *Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks*. Paper presented at the Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, Chicago.

Grier, W. A. (2007). *Credit analysis of financial institutions* (2nd ed.). London: Euromoney.

Llewellyn, D. T. (1996, 8-9 July). *Banking in the 21st Century: The Transformation of an Industry*. Paper presented at the Reserve Bank of Australia 1996 Conference The Future of the Financial System.

SCHEDULE

See Moodle for course schedule details and resources

LINKAGES TO OTHER PAPERS

Pre-requisites: FINA311 and FINA312

DEPARTMENTAL POLICY
