Global Markets and Institutions

First Assignment

Chapter 7 :

1 : Economy of scale helps the existence of financial intermediaries because thanks customers deposit, multiple customers can lend money to borrowers with lower interest (the overall operating costs are lower).

2 : Dating can solve the adverse selection problem, because the adverse selection occurs before a contract is signed. Giving more transparent information should be a method to vanish averse selection (e.g : lemon cars, the sellers has more information on the product than the buyer).

3 :

Chapter 8 :

1 : Financial crisis = Major disruption in financial markets characterized by sharp declined in asset prices and firm failures. Asymmetric creates barrier between savers and borrowers, so it helps to define a financial crisis, because borrowers don't trust lenders so it slows down the financial system.

2 : The mortgage brokers who originates the loans didn't make effort to verify if the borrower could pay off (or not) the loan. But it was not their problems, because brokers were paid depending on the quantity of loans they contracted (whether the borrowers are not bankable). The brokers encourage the households to falsify their information, so they can contract a mortgage loan which is above their earnings, and the banks didn't know. The residential housing known a boom and bust, asset price boom and bust, and increase in uncertainty between 2002 and 2006, which led to the global financial crisis of 2007-2009 (then follow banking crisis, and debt inflation.)

3 : The lending practices started to be revealed which conducts the value of the house being decreased (even below the price of the loan). Home owners just gave back the keys of their houses. The decline in the US housing market led the value of mortgage-backed securities to collapse. So the assets value decreased, so did the net worth of the banks. The banks were weakened and reduced money lending, meaning more of financial frictions in financial markets.

4 : Financial frictions : The financial frictions are the financial barriers made by the lack of information from the borrower to the lender. This lack of information is the first lever of the first stage of a financial crisis.

5 : Failure of a major financial institution lead to an increase in adverse selection and moral hazard, because it becomes hard to acquire information on the credit worthiness of banks.

Chapter 17 :

1 : -reserves

-securities

-commercial loans

-physical capital

2 : I would probably not, because if I buy stocks in a bank, I would want the valor of the stocks increase, so I earn more money thanks to the growth of the value of the share. The fact is the lower bank capital is, higher is the return on assets. Which means, less the bank has capital (and higher risks), more the return on equity is high. (Return On Equity = Return On Assets x Equity Multiplier).

3 : I would probably accept to contract him a loan with that customer because I have 4 ways to have liquidity :

-borrowing from others banks corporations

-selling securities

-borrowing from the Fed

-calling in or selling off loans

4 : They have to hold fewer excess reserve, so they can contract loan on very short term (like a day), without using the 4 strategies told above to lend money. So the banks are sure to have enough liquidity to contract loans, even if the cashflow is higher due to the increase of borrowings.

Quantitative problems :

1 : $1.33m − $0.84m + $0.22m + $1.48m = $2.19m

2 : ROE = ROA × EM

0.15 = 0.01 × EM

EM = 15 = assets/equity

So equity/assets = 6.66%. This is a well-capitalized bank.

3 : When issued, the required payment is:

PV = $150,000, I = 7.8/12, N = 360, FV = 0

Compute PMT.

PMT = $1,079.81

After 36 months, the mortgage balance is:

PMT = $1,079.81, I = 7.8/12, N = 324, FV = 0

Compute PV. PV = $145,764.43

However, at current rates, the remaining cash flows are worth:

PMT = $1,079.81, I = 13/12, N = 324, FV = 0

Compute PV. PV = $96,637.64

Wiggley S&L expects to take a loss of $49,126 if it sells the mortgage.

4: The sale would be recorded as:

Debit		Credit	
Cash	$96,638	Mortgage	$145,764
Capitalized Loss	$49,126		

Then, each year for the next 27 years the loss would be written off:

Debit		Credit	
Loss Expense	$1,819.48	Capitalized Loss	$1,819.48