

FINA 1303

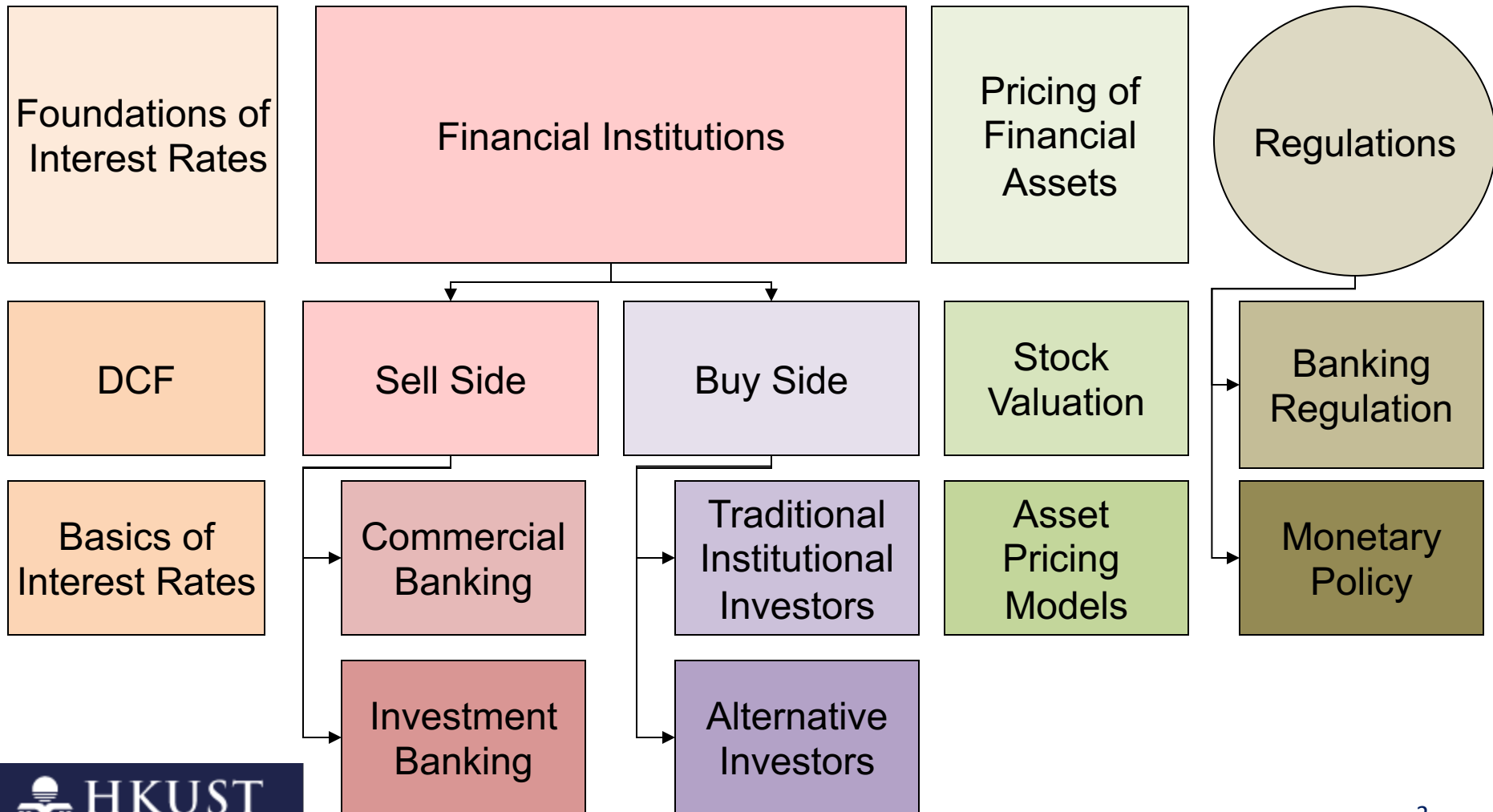
FOUNDATIONS OF FINANCIAL INSTITUTIONS

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Course Map

Overview



Course Map

Overview

Financial Institutions

- **Role of Financial Institutions**
- Types of Financial Institutions
- Financial Intermediation
- Conflicts of Interest

Role of financial institutions

Financial services industry links organizations needing capital with those able to provide it



NYSE and Wall Street

Source: Wikipedia



Major contributor to economy in UK, US, HK....

City of London, the Square Mile

Source: www.freefoto.com

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Types of Financial Institutions

Financial Intermediaries

Depository Institutions

- Commercial Banks
- Credit Unions
- Mutual/Savings Banks
- Building Societies

Other Financial Intermediaries

- Insurance Companies
- Pension Funds
- Mutual Funds
- Money Market Funds
- Finance Companies

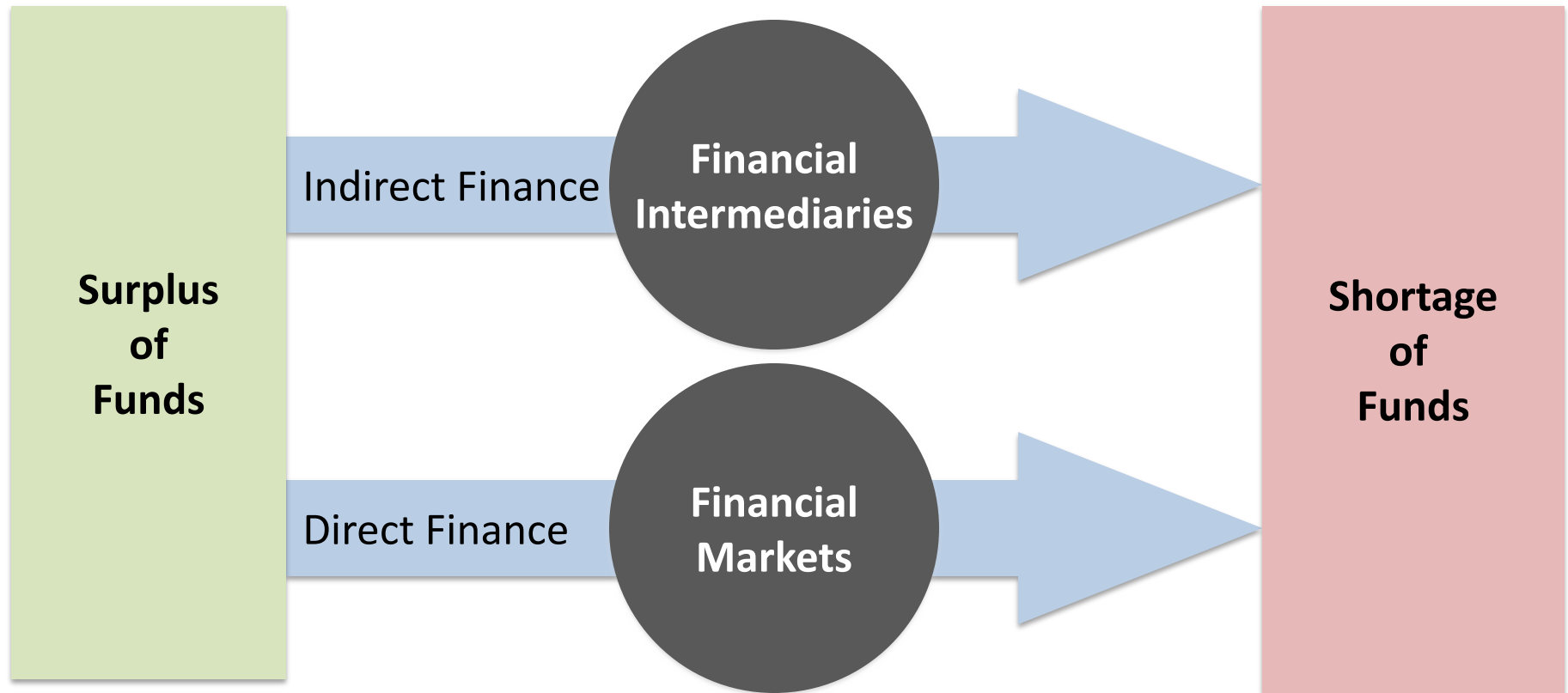
Other Financial Institutions

- Securities Firms
- Brokers
- Dealers
- Investment Banks
-

Issue checkable deposits

Issue financial claims

Financial System



Financial institutions that are **not** financial intermediaries

- Brokers
- Dealers
- Investment banks
- Custodians
- Trustees

Brokers

- Act **on behalf** of their clients
- Charge a commission (fee) for the service
- Do **NOT** take positions
- Examples:
 - Real estate broker: will put together a buyer and a seller and charge a fee
 - Insurance broker: will find the “right” policy for his clients among various possible insurance companies
 - Stock broker: will execute orders on behalf of clients on the exchange



Dealers

- Act as **PRINCIPAL**
- Takes **positions** and carries inventories
- Makes money from the difference (the **spread**) between the price at which he buys the assets (bid) and the price at which he sells them (offer)
- **Market makers** are dealers who post 2-way prices and “make markets” thus providing liquidity
- Examples:
 - FX dealer
 - Primary dealer in government securities
 - Securities dealers in certain exchanges



SUMMARY (KLO)

- Classification of FIs
- Dealer definition
- Broker definition

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Financial Intermediaries

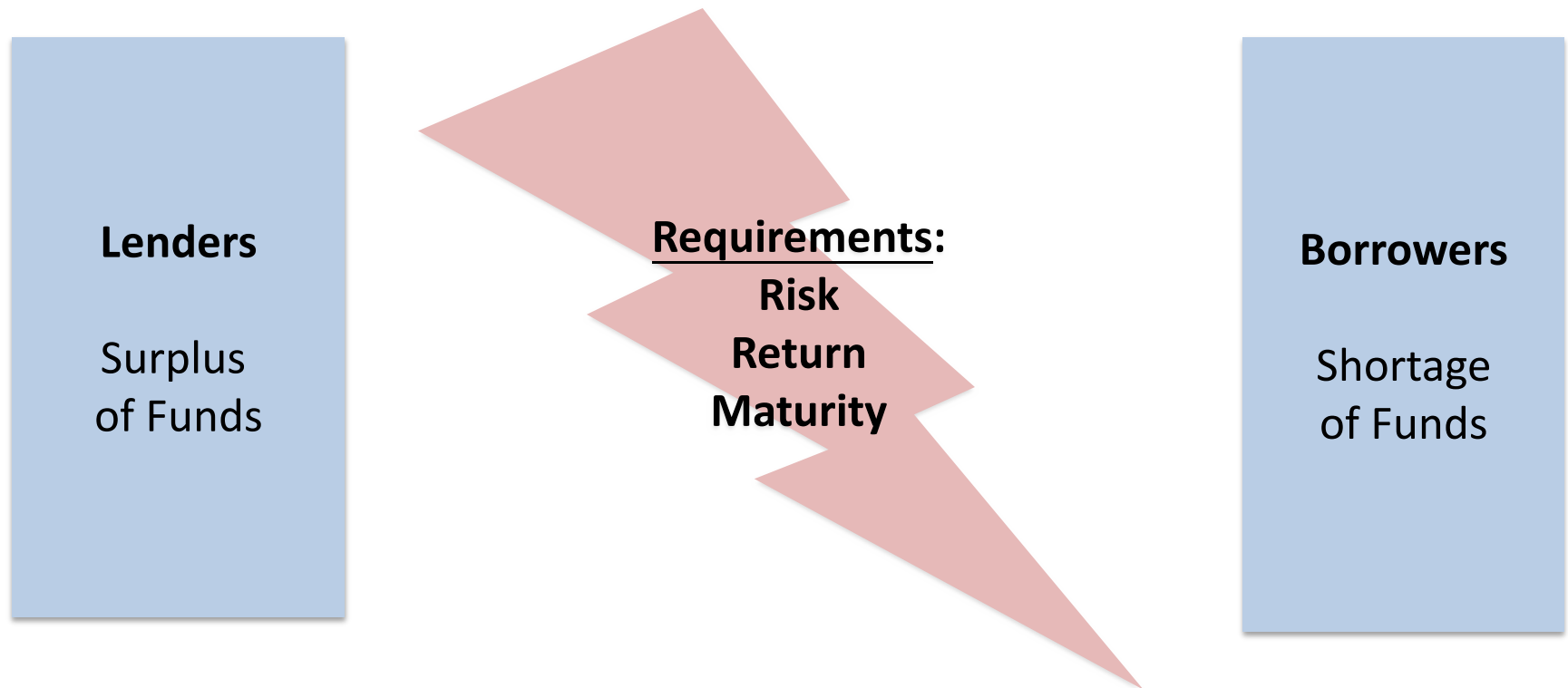
Deposit Intermediaries

- Commercial Banks
- Savings Banks
- Mutual Banks
- Post Office
- Central Bank

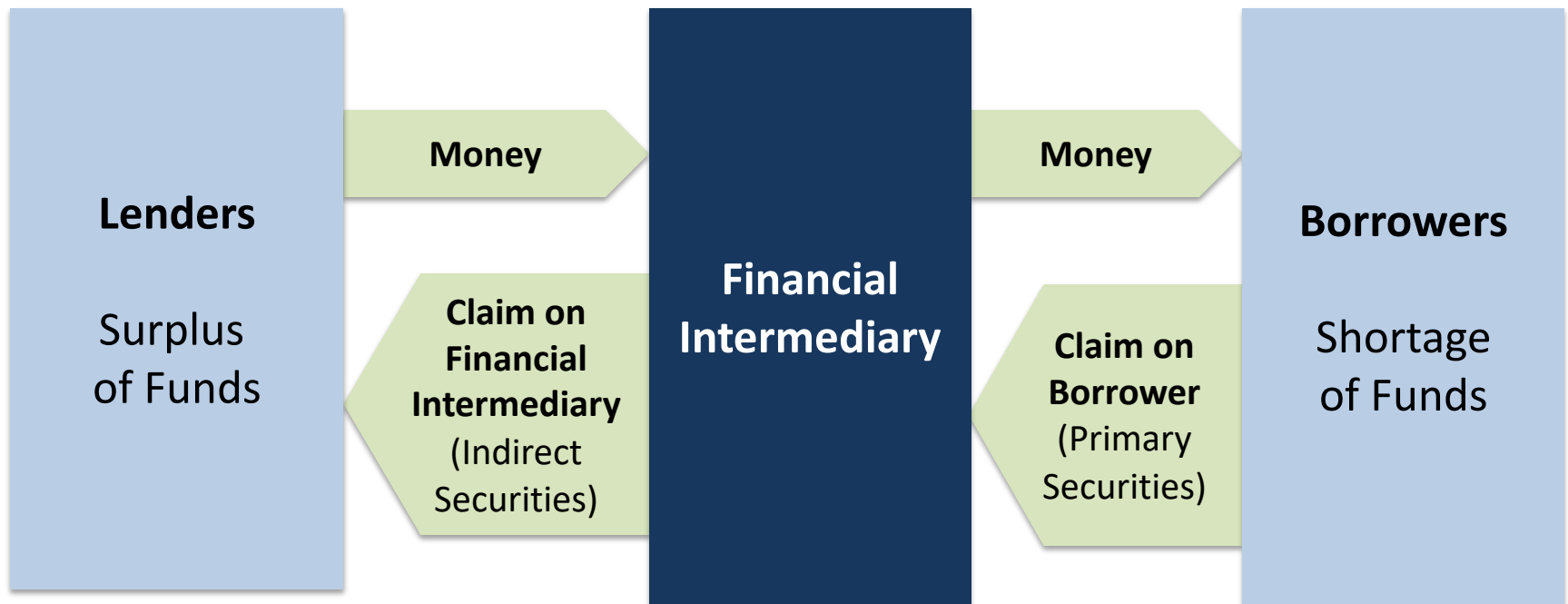
Non-Deposit Intermediaries

- Contractual Intermediaries
 - Insurers
 - Pension Funds
- Portfolio Institutions
 - Unit trusts
- Other FIs
 - Finance Companies

Financial Intermediation



Financial Intermediation (Cont)



Function of Financial Intermediaries

- Engage in process of **indirect finance**
- **More important source of finance than securities markets**
- Reduce **transactions costs** and **asymmetric information**
 - Reduce transactions costs by developing expertise and taking advantage of **economies of scale**
 - Low transaction costs increase profits and allow some intermediaries to provide **liquidity services**
 - Checking accounts that enable them to pay their bills easily
 - Depositors can earn interest on checking and savings accounts and yet still convert them into goods and services whenever necessary

Example?

The time & money spent on carrying out financial transactions

?

The reduction in transaction costs per dollar of transaction as the size (scale) of transaction increases

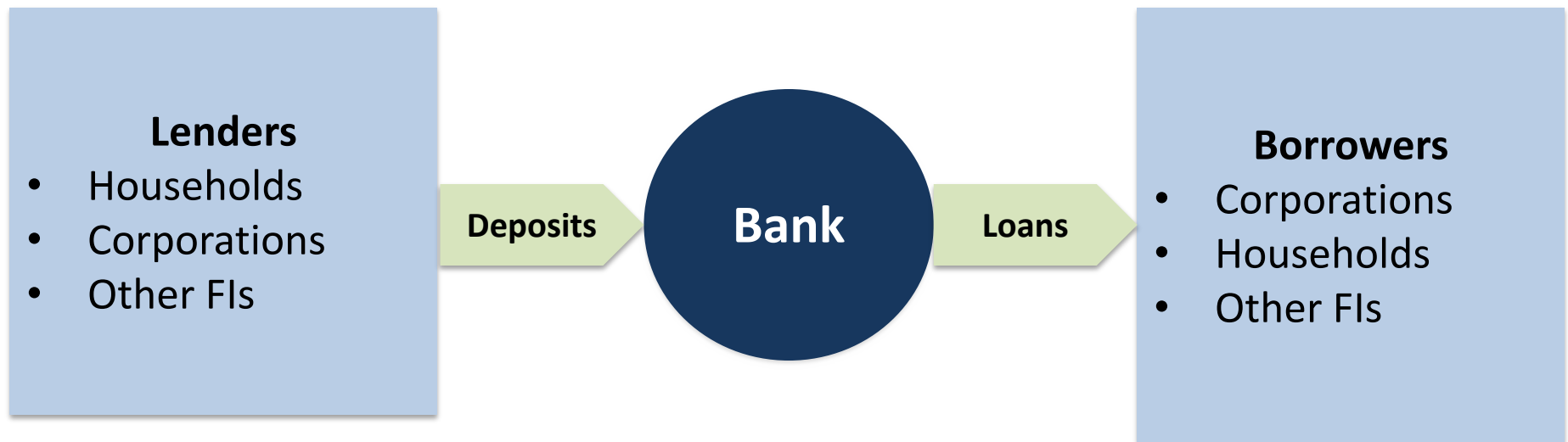
Function of Financial Intermediaries

- Another benefit made possible by the financial intermediaries' low transaction costs is that they can **help reduce the exposure of investors to risk**, through a process known as **risk sharing**
 - Financial intermediaries create and sell assets with lesser risk to one party in order to buy assets with greater risk from another party
 - This process is referred to as **asset transformation**, because in a sense risky assets are turned into safer assets for investors
- Banks can also enjoy **economies of scope** by providing multiple services to their customers

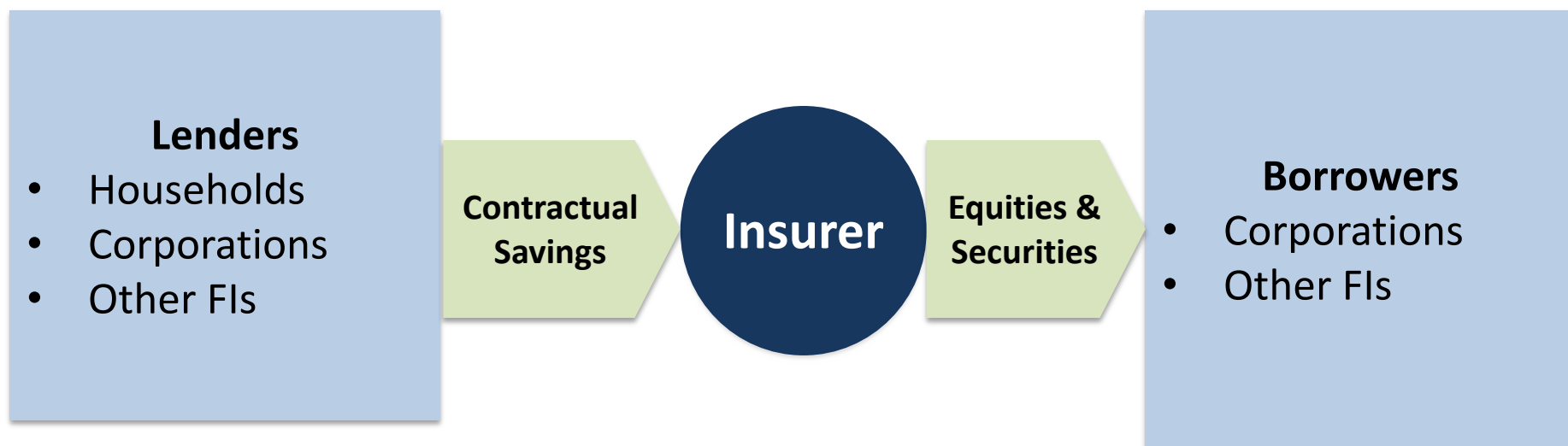


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Banks as Financial Intermediaries



Insurers as Financial Intermediaries



Services performed by financial intermediaries

- **Monitoring Costs**
 - Collect information and monitor firms activities at a lower cost than individual actors due to economies of scale
- **Liquidity and Price Risk**
 - The financial claims issued by financial intermediaries give savers liquidity and lower price risk
- **Transaction Cost Services**
 - Are reduced as a result of economies of scale

Services performed by financial intermediaries (Cont)

- Maturity Intermediation
 - Financial intermediaries bear and manage the risk of mismatching the maturities of their assets and liabilities
- Denomination Intermediation
 - By pooling their savings, financial intermediaries allow small investors to buy assets which would have been inaccessible due to large minimum investment size (e.g. bonds)

Services provided by financial intermediaries benefiting the overall economy

■ Money Supply Transmission

- Depository institutions are the conduit through which monetary policy actions impact the rest of the financial system and the economy in general

■ Credit Allocation

- Financial intermediaries are the major and sometimes only source of financing for particular sectors of the economy

■ Intergenerational Wealth Transfers

- Financial intermediaries such as life insurance companies or pension funds provide savers with the ability to transfer wealth from one generation to another

■ Payment Services

- The efficiency with which the depository institutions provide payment services directly benefits the economy

Test Your Understanding

- Is a mutual fund a financial intermediary?
 - Yes
 - No
- Is a stock broker a financial intermediary?
 - Yes
 - No
- How do dealers make money?
 - They charge a commission
 - The difference between bid and offer



SUMMARY (KLOs)

- Understanding financial intermediation
- Distinguishing financial and non-financial intermediaries
- Understanding key services performed by financial intermediaries


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- **Conflicts of Interest**

What are conflicts of interest and why are they important?

- Financial intermediaries engage in a variety of activities to collect, produce, and distribute information. By providing multiple services, they realize **economies of scope**.
- However, these services may be competing with one another, and this creates the potential for a **conflict of interest**:
 - Whereby one party has **incentives** to act in its own interest rather than in the interests of the other party
 - Conflicts of interest generate **incentives** to provide false or misleading information
- We care about these conflicts of interest because a reduction in the quality of information increases the presence of asymmetric information.

Source: Mishkin/Eakins

Ethics and Conflicts of Interest

Recent cases of conflict of interest:

- Underwriting and research in investment banking
- Auditing and consulting in accounting firms
- Credit assessment and consulting in credit-rating agencies
- Universal banking
-

“I try not to break the rules, but merely to test their elasticity”

Bill Veeck as cited in FT 24/8/07 article “Derivatives Dodges”

Approaches to remedying Conflicts of Interest

- Leave It to the Market
- Regulate for Transparency
- Supervisory Oversight
- Separation of Functions
- Socialization of Information Production

Sarbanes-Oxley “SOX” Act of 2002

Section 404

requires an annual "internal control report", which must be certified by auditors and personally signed off by two executives.

Passed following the public outcry over corporate scandals. Six major components:

- Established the Public **Company Accounting Oversight Board** to supervise accounting firms
- Prohibited public accounting firms from engaging in non-audit services to a client it is also auditing
- Members of the board’s audit committee must be **independent**
- Required the **reporting of off-balance sheet activities**
- Appropriated additional funding for the SEC
- Increased the charges for white-collar crimes and obstruction

Source: Mishkin/Eakins

Global Legal Settlement of 2002

The New York Attorney General and several of the largest U.S. investment banks reached an agreement which key terms included:

- **\$1.4 billion** in fines
- Firms must sever the link between underwriting and research activities
- **Spinning** is banned
- Firms must make public analyst recommendations and target prices
- Brokerage firms required to obtain third-party, independent research for their clients

“The widespread practice on Wall Street of giving shares of IPOs -- which often jumped in value in the first days of trading -- to preferred and prospective clients in what appeared to be an effort to bolster investment banking business”

Source: NY Times 28/9/02

Asymmetric Information: Adverse Selection and Moral Hazard

Adverse Selection

- One party in a transaction has better information than the other party
- **Before** transaction occurs:
Potential borrowers most likely to produce adverse outcome are ones most likely to seek loan and be selected

Moral Hazard

- One party has an incentive to behave differently once an agreement is made between parties
- **After** transaction occurs:
Hazard that borrower has incentives to engage in undesirable (immoral) activities making it more likely that won't pay loan back

Examples?

Current Issues

- Central banks face moral hazard in subprime crisis
- Rating agencies face increased scrutiny as result of conflict of interest in rating of structured products
- Government bailout vs. bonuses
- Insider trading
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Group 10:Conflicts of interest in banks: find recent example in Asia, explain issue, implications

- Video link
- <https://www.youtube.com/watch?v=EvQ0o68ck38>
- Article link
- <https://www.cnbctv18.com/business/companies/hdfc-bank-non-executive-director-srikanth-nadhamuni-resigns-12548782.htm>

Test Your Understanding

- What is moral hazard?
- What is adverse selection?
- The global legal settlement of 2002 addressed conflicts of interest in which type of financial institution?



SUMMARY (KLOs)

- Understand conflicts of interest
- Sarbanes-Oxley
- Legal Settlement of 2002
- Ways to remedy conflicts of interest