Chapters 8, 17, 18, 23, Regional Bank crises, the SVB failure, FTX implosion, and Credit Suisse collapse.

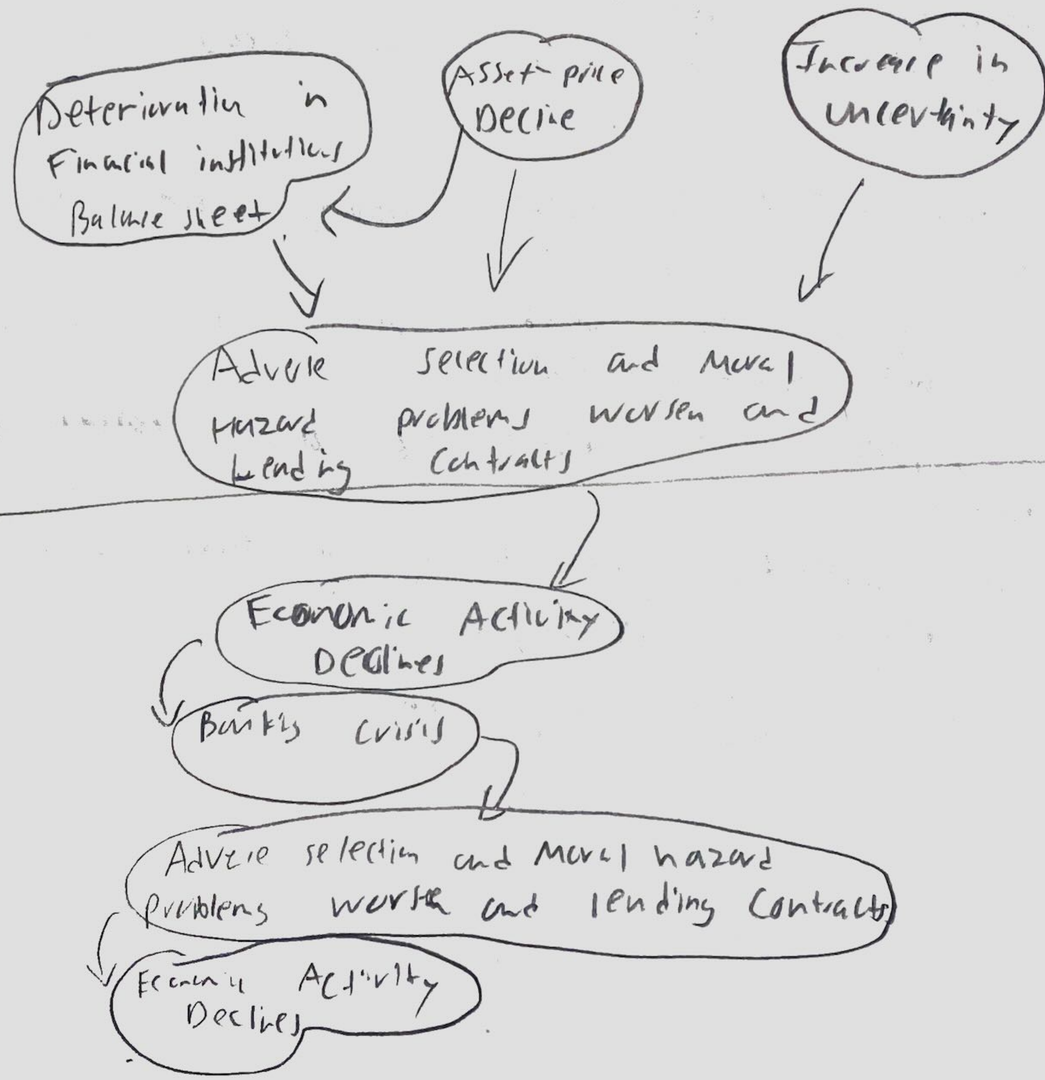
Chapter 8: Why do financial crises occur and why are they so damaging to the economy.

A functional financial system is critical to a robust economy.
- However, both moral hazard and adverse selection are still present. To study these problems is the basis for understanding and defining a financial crisis.

Asymmetric information creates barriers between savers and firms with productive investment opportunities.

Financial crisis occurs when information flows in financial markets experience a particularly large disruption, thus causing financial markets to stop functioning completely.

Stage one
Initial phase:



Stage two
Banking crisis:

Stage 3

Debt deflation:

Unanticipated Decline in Price level

Adverse Selection and Moral Hazard Problems worsen and lending Contracts

Economic Activity Declines

Stage 1: Initial phase

Financial crisis can begin in several ways:
- Credit Boom and Bust
- Asset-Price Boom and bust
- Increase in Uncertainty

- financial crisis can begin with mismanagement of financial liberalization or innovation:
  - elimination of restrictions
  - Introduction of new types of loans ~~or~~ other financial products.

Either can lead to a credit boom, where risk management is lacking.

- Government safety nets weaken incentive for risk management. Depositors ignore bank risk-taking.
- Eventually, loan losses accrue and asset values fall, leading to reduction in capital.
- Financial institutions cut back in lending, a process called deleveraging. Banking funding falls as well.
- As Financial institutions cut back on lending, no one is left to evaluate firms. The financial system losses its primary institution to address adverse selection and moral hazard.
- Economic spending contracts as loans become Scarce.

Financial crisis can also begin with an asset-price boom and bust: - A pricing bubble starts, where asset values exceed their fundamental values.

- When bubble burst and price fall, corporate net worth falls as well. Moral hazard increases as firms have little to lose.

- Financial institutions also see a fall in their assets, lending again to deleveraging.

Financial crisis can also begin with increase in uncertainty:

- periods of high uncertainty leads to crisis, such as stock market crashes or the failure of a major financial institution.
- Information is hard to come by, moral hazard and adverse selection problems increase, reducing lending and economic activity.

Stage two: Banking Crisis

Deteriorating balance sheets lead financial institutions into insolvency. If severe enough, these factors can lead to a bank panic.

- Panics occur when depositors are unsure which banks are insolvent, causing all depositors to withdraw all funds immediately.

- As cash balances fall, financial institutions must sell assets quickly, which further deteriorates their balance sheet.

- Adverse selection and moral hazard become severe, it takes years for a full recovery.

Stage Three: Debt Deflation

If the crisis also leads to a sharp decline in prices, debt deflation can occur, where asset prices fall, but debt levels do not adjust, increasing debt burdens.

- This leads to a increase in adverse selection and moral hazard, which is followed by decreased lending.
- Economic activity remains depressed for a long time.

Liquidity Management - No excess Reserves

Reserves requirement = 10%, Excess reserves = $0 million

- with no excess reserves, banks has a shortfall - not enough required reserves.

How can the bank recover? Borrow from other banks, sell securities, borrow from the fed, reduce loan portfolio,

Asset Management: is the attempt to earn the highest possible return on assets while minimizing the risk.

1. Get borrowers with low default risk, paying high interest rates.
2. Buy securities with high return, low risk
3. Diversify
4. Manage liquidity

Liability Management: Managing the source of funds, from deposits, to CDs, to other debt.

- Banks manages both sides of the balance sheet together, whereas it was more separate in the past.
  Manage via the asset-liability management (ALM) committee

- Explains the increased use of CDs and loans over checkable deposits in recent decades.

Capital adequacy management - is the process of evaluating a financial institution's ability to meet its financial obligations and absorb potential losses.

The practicing Manager

What should a bank manager do if she feels the bank is holding too much capital?
- Sell or retire stock
- Increase dividends to reduce retained earnings
- Increase asset growth via debt (like CDs)

What if the bank manager feels the bank is holding too little capital?
- issue stock
- Decrease dividends to increase retained earnings
- slow asset growth (retire debt)

Measuring Bank performance: Measuring bank performance requires a look at the income statement:
- operating income
- operating Expenses
- Net operating income

Chapter 17: Banking and the Management of Financial Institutions

Balance sheet is list of a bank's assets and liabilities

- Banks invest their liabilities (sources) into assets (uses) in order to create value for their capital providers.

Liabilities:

Checkable Deposits: allows depositors to write checks to 3rd parties
- Makes up about 10% of bank liabilities

Nontransaction Deposits: accounts from which depositor cannot write checks.
- primary source of bank liabilities (50%)
- Highest cost of funding, but most stable for bank.

Borrowings: funds from the Federal Reserve Systems, other banks, and corporations.
- More volatile than other liabilities, make up 19% of bank liabilities.

Bank Capital: is the source of funds supplied by the bank owners.
- 11% of assets.

Assets

Reserves: funds held in account with the Fed
Required reserves represent what is required by law under current required reserve ratios.
- Any reserves beyond this area called excess reserves.

Cash items in Process of Collection: checks deposited at a bank, funds from other bank have not yet been transferred.
Deposits at other banks: usually deposits from small banks at larger banks (corresponded banking)

Reserves, cash items in process of collection, and Deposits at other banks are collectively referred to as cash items in balance sheet.

Securities: - US government/agency debt
- municipal debt
- other (non-equity) securities

- These make-up about 20% of assets.
- Short-term Treasury debt is a secondary reserve b/c of its high liquidity.

Loans: bank's income-earning assets (business loans, auto loans, and mortgages)
- Not very liquid / and about 53% of assets.

Other assets: bank buildings computer systems, and other equipment

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Banks engage in asset transformation (when banks takes your savings deposits and uses the funds to make mortgage loan)
- when a bank receives deposits, reserves increase by equal amount; when bank loses deposits, reserves drop by equal amount.

General Principles of Bank Management

The bank has 4 primary concerns: (1) Liquidity management
(2) Asset management (Managing credit risk and Managing interest-rate risk)
(3) Liability management
(4) Managing capital adequacy

- bank must also manage credit risk and interest-rate risk.

Chapter 18: Financial Regulation

Asymmetric information, moral hazard, and adverse selection explain the regulatory environment in banking.

Bank panics and the Need for Deposit Insurance:

Prior to FDIC insurance, bank failures meant that depositors lost money

- Good banks need to separate themselves from bad banks
- The inability of the depositors to assess the quality of a bank's assets can lead to panics.
- with a safety net, depositor will not flee the banking system at the 1st sign of trouble

FDIC handles failed banks through the payoff method, and the purchase and assumption method.

- The FDIC insurance creates moral hazard incentives for banks to take on greater risk.
- The FDIC insurance creates adverse selection.
- Regulators are reluctant to let the largest banks fail b/c of the potential impact on the entire system.
  - Ex) when Continental Illinois failed, all deposits were insured, as were bond holders.

Nine Basic Types of Financial Regulation:

1) Restrictions on asset holdings
2) Capital requirements
3) Prompt corrective action
4) Chartering and examination
5) Assessment of risk manage
6) Disclosure requirements
7) Consumer protection
8) Restrictions on competition
9) Macroprudential regulation

Types of financial Regulation

1) Restriction on Asset Holdings

-Regulators limit the type of assets banks may hold as assets.

2) Bank Capital Requirements

-Banks are also subjected to capital requirements. Banks are required to hold certain level of capital (bank equity) that depends on the type of assets that the bank holds.

3) Prompt Corrective action

-Undercapitalized banks is more likely to fail and more likely to engage in risky activities. The FDIC improvement Act requires the FDIC to act quickly to avoid losses to the FDIC.

WSJ The Disconcerting signal behind China's Epic Bond Rally

Chinese gov bonds is very attractive to investors, driving a buying spree. The demand has lowered yields on the 10-year bond to record lows. The People's Bank of China (PBOC) is concerned that this bond rally reflects waning confidence in China's economic growth and could potentially harm smaller banks if interest rates rise suddenly.

The central bank has taken steps to cool the bond market by encouraging large banks to sell bonds and expressed concerns about financial risks. Economist suggest that the PBOC's actions may be more politically motivated, as low bond yields signal economic weakness.