

Lecture notes #1

# Financial Intermediation and Regulation

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# What is financial intermediation?

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- Financial intermediaries specialize in bringing together:
  - People seeking financial resources for productive uses
  - Owners of financial resources
- Key aspects:
  - Reduce transaction costs
  - Reduce monitoring costs
  - Risk intermediation
    - Default
    - Price risk
    - Maturity and size
    - Diversification
  - Increase liquidity
- Key distinctions
  - Loans (borrowing from banks)
  - Securities (borrowing from public)



# Depository institutions

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- Commercial banks
- Thrifts
  - S&Ls
  - Savings Banks
  - Credit Unions
- Balance sheet
  - Assets
    - Loans (C&I, mortgage, consumer)
    - Securities (investment and trading)
  - Liabilities
    - Deposits
    - Borrowings

# Securities firms

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- Nature of business:
  - Underwrite and distribute securities (investment banking)
  - Market making (brokering and dealing)
  - Advising (M&A, restructurings)
  - Merchant banking (credit and equity investments)
  - Investment management
- Balance sheet
  - Assets:
    - Repurchase agreements.
    - Long positions in securities and commodities.
  - Liabilities:
    - Repurchase agreements major source of funds.
    - Securities and commodities sold short.
  - Capital levels much lower than levels in depository institutions.

# Insurance companies

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- Life insurance companies
  - Long-term liabilities
    - Net policy reserves to meet policyholders' claims.
  - Long-term assets
    - Need to generate competitive returns on savings components of life insurance policies.
    - Bonds, equities, government securities
    - Policy loans
- Property and casualty insurance companies
  - Balance sheet similar to life insurance companies.
  - Major liabilities: loss reserves, loss adjustment expense and unearned premiums.

## Other types of financial institution

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- Mutual funds
  - Assets can consist of debt, equity, or other investments
  - Liabilities consist of equity in the form of mutual fund shares
  - *Hedge funds* are basically unregulated mutual funds, not widely available to public
- Finance companies (e.g., HFC, GE Capital, GMAC)
  - Assets can be commercial or consumer loans
  - Liabilities are commercial paper and longer-term debt
- Government sponsored enterprises
  - Fannie Mae, Freddie Mac (U.S.)
  - Landesbanks (Germany)
- Multinational institutions (World Bank, European Bank for Reconstruction and Development)

# Financial intermediaries are connected by financial markets

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- Money markets involve short-term debt instruments (< 1 year)
  - Examples: Treasury bills, Eurodollars, repurchase agreements, Fed funds, large CDs, and commercial paper
  - Participants: Mostly financial institutions, fund managers, and central banks
- Currency markets connect money markets across national boundaries through the exchange of FX
- Capital markets involve medium- and long-term debt (> 1 year)
  - Examples: Bond markets, stock markets
  - Participants: Banks, securities firms, investment funds, and corporate borrowers

# How financial markets are regulated

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- Market discipline
  - Competition
  - Reputation
- Legal environment
  - Property rights protected
  - Contracts enforced
- Government agencies

# Rationale for government regulation

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- Safety of deposit insurance fund
- Protection of retail investors
- Stability of payments system
- Monetary policy concerns

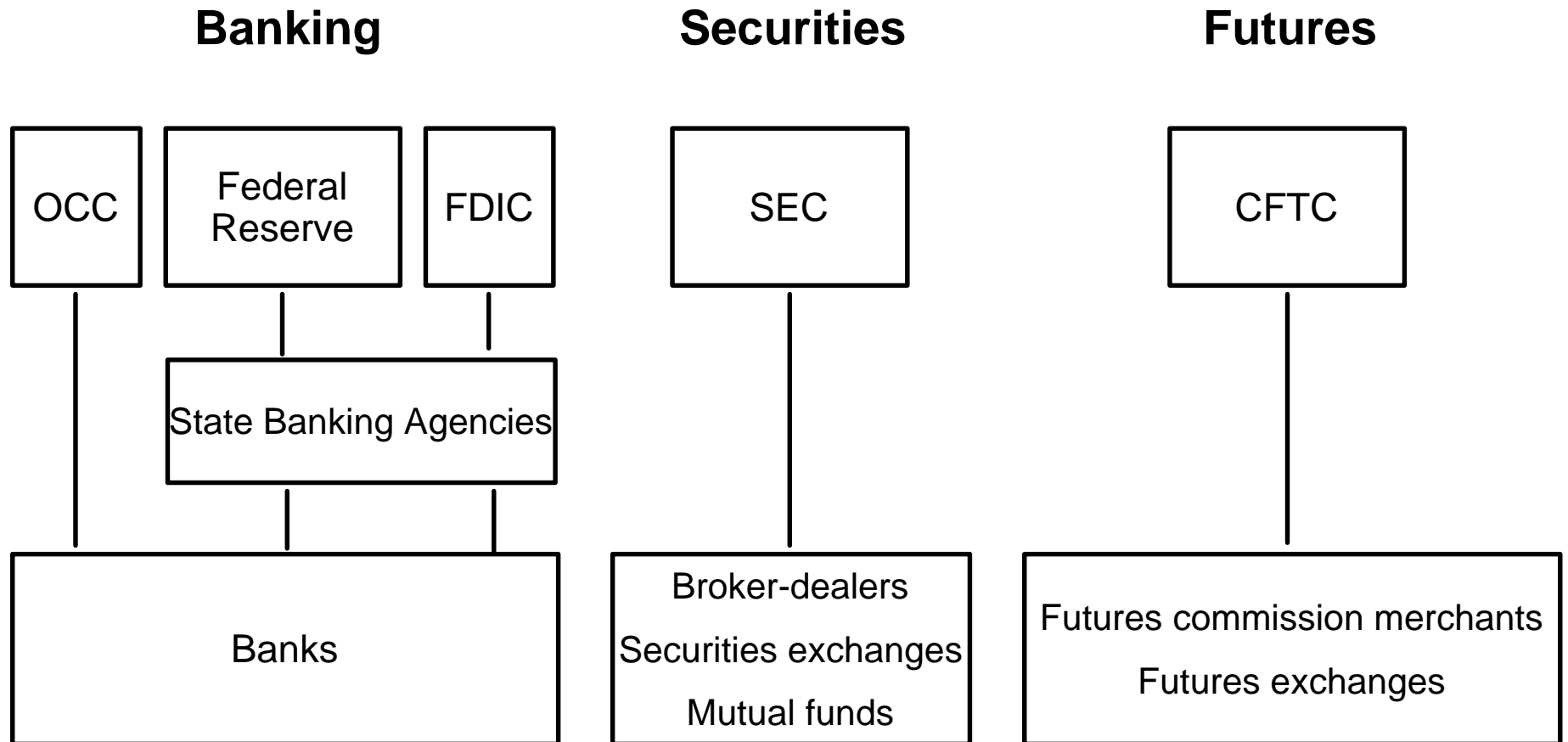
# Forms of government regulation

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- Product
  - Glass-Steagall Act
  - Bank Holding Company Act
- Geographical
  - Branching restrictions at state level
  - McFadden Act and Bank Holding Company Act
- Safety and soundness
  - Bank examination by regulatory agencies
  - Capital adequacy standards
- Investor protection (securities laws)
- Consumer protection (e.g., Fair Lending Act)
- Credit allocation (e.g., Community Reinvestment Act)

# U.S. financial regulatory structure

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Insurance companies in the U.S. are regulated at the state level

# Other financial regulatory structures

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- United Kingdom
  - Financial Services Authority combines all financial regulation in one agency (replaced Bank of England and Securities and Futures Authority)
- Canada
  - Federal regulation of banks (Office of the Superintendent of Financial Institutions)
  - Provincial regulation of securities firms
- Germany
  - Federal supervisory agencies for banks and for securities firms
  - Deutsche Bundesbank not a primary regulator
- Japan
  - Financial Services Agency replaced Ministry of Finance in 2000 as regulator of all financial institutions

# What is risk management?

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‘The fact is that bankers are in the business of managing risk. Pure and simple, that is the business of banking.’

*Walter Wriston, former Citicorp CEO*

- In a financial firm, risk management can refer to:
  - Trading
  - Insurance
  - Credit
  - Centralized risk management
- This course will emphasize:
  - Risk measurement
  - Risk control

# Risks faced by financial firms

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## The two major categories

- Credit risk
  - Uncertainty about a counterparty's ability or willingness to fulfill its contractual obligations
  - **Systemic risk** arises from concern that default by one institution could cause insolvency of other institutions
- Market risk
  - Uncertainty about how changes in market variables will affect the value of assets and liabilities or cash flows

# Risks faced by financial firms

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## Other forms of risk

- Business risk
  - Often distinguished from **financial risks**
  - ‘Core competencies’
  - Strategic risk
- Operational risk
  - Internal controls
  - Model risk
  - Execution
  - Systems and technology
  - Reputation

# How banks manage risks

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- Capital serves as a buffer against unanticipated losses
  - Economic capital represents the risk-taking capacity of the bank
  - Regulatory capital refers to the minimum level of capital that regulators consider safe
- Active risk management
  - Policies and controls
  - Risk measurement
- Capital levels and active risk management are to some extent substitutes for each other