BFF2401 – Commercial Banking & Finance Exam Notes

Topic 1 – Financial Institutions' Specialness

The Financial System

- The role of the financial system is to facilitate financial transactions through the creation, sale and transfer of financial assets
- There are three components:
    - Financial Institutions
    - Financial Markets
    - Financial Instruments

Financial Institutions' Specialness

- Without financial institutions
    - Excess savings could only be held as cash, physical assets or invested in corporate securities
    - The flow of funds is likely to be low
    - Little or no monitoring would occur
    - Risk of investments would increase
- In the real world covenants partially alleviate these problems
- Households might find direct investments in corporate securities unattractive because of:
    - Monitoring costs
    - Liquidity costs
    - Price risk

- Financial institutions fulfil two major functions
    - Brokerage function
        - Economies of scale
    - Intermediation function
        - Primary securities
        - Secondary securities
- Financial institutions are better able to resolve the costs facing an individual making a direct investment

Monitoring Costs (Agency Costs)

- An agency cost that arises when bondholders take steps to ensure that the firm adheres to protective covenants in the bond indenture. Similarly, shareholders take steps to ensure that management is acting in the best interest of the owners, i.e., that managers are maximizing the wealth of shareholders.
- Agglomeration of funds resolves the following problem
    - Greater incentive for information collection and monitoring activities (Free-rider problem and delegated monitor)
    - Development of new secondary securities to more effectively monitor

Price and Liquidity Risk

- The risk of a decline in the value of a security or a portfolio. Can be minimized with the use of diversification, however market risk cannot be diversified away.
- Financial institutions provide secondary claims to household savers: high liquidity
- Able to diversify some of existing portfolio risk

Other Special Services

- Reduced transaction costs
  - Economies of scale in transaction costs
    - Purchase of assets in bulk
    - Lower buy – sell spread
- Maturity Intermediation
  - Maturity intermediation function
  - Ability to risk mismatched assets and liabilities

Other Aspects of Specialness

- Transmission of Monetary Policy
  - Institutions' liabilities play significant role in the transmission of monetary policy
  - Money supply in Australia
    - M1: Currency + Bank current deposits
    - M3: M1 + all other ADI deposits (including CD's)
    - Broad Money: M3 + non-deposit borrowings from all financial institutions less currency and bank deposits by registered FIs and cash management trusts.
- Credit Allocation
  - Financial institutions are the major source of finance in particular sectors of an economy
    - US and UK: Residential real estate
    - Australia: Farming
- Intergenerational Wealth Transfer or Time Intermediation
  - Wealth transfer between youth and old age
  - Superannuation and pension funds
- Payment Services
  - Services
    - Cheque clearing
    - Real-time gross settlement (RTGS)
  - Clearing Systems
    - Australian Payments Clearing Association (APCA)
    - Reserve Bank Information and Transfer System (RITS)
    - Austraclear System
    - Clearing House Electronic Sub-register System (CHESS)
- Denomination Intermediation
  - Transforming small deposits into large loans

Measuring Shareholder Value/Wealth

- A firm's shareholder value refers to the wealth accruing to shareholders from their ownership of shares in that firm's dividends and capital gain
- Practical measures of SHW
  - Share prices
  - Market capitalisation – Number of shares issued x share price
- Theoretical measure of shareholder wealth
  - Requires a mathematical model
  - Presents value of expected future CFs discounted at investors' required rate of return
  - $P_0 = CF/(1+r)$

Risk-Return Trade Off

- Credit Risk
  - Credit risk refers to the risk that a borrower will default on any type of debt by failing to make required payments. The risk is primarily that of the lender and includes lost principal and interest, disruption to cash flows, and increased collection costs
- Liquidity Risk
  - Liquidity risk is the risk that a given security or asset cannot be traded quickly enough in the market to prevent a loss
- Interest Rate Risk in the banking book
  - Interest Rate Risk in the Banking Book (IRRBB) is the risk to interest income arising from a mismatch between the duration of assets and liabilities that arises in the normal course of business activities
- Market Risk
  - Interest rate risk (trading book)
  - Equity price risk
    - Equity price risk is the risk that the fair value of equities decreases as a result of changes in the levels of equity indices and the value of individual stocks
  - Commodity price risk
    - The threat that a change in the price of a production input will adversely impact a producer who uses that input
  - Foreign exchange risk
    - Foreign exchange risk is a financial risk that exists when a financial transaction is denominated in a currency other than that of the base currency of the company.
- Operational risk
  - Operational risk is defined as the risk of loss resulting from inadequate or failed processes, people and systems or from external events.
- Insolvency risk
  - Insolvency risk is the risk of a person becoming insolvent
- Optimum = Risk-Return mix at which shareholder value is maximised

Topic 2 – Bank Regulation

Key Financial Regulators

- Reserve Bank of Australia (RBA)
    - Responsible for monetary policy, systemic stability, and the payments system
- Australian Prudential Regulation Authority (APRA)
    - Responsible for prudential regulation and supervision of deposit-taking institutions (including banks), insurance, superannuation.
- Aust. Securities and Investments Commission (ASIC)
    - Responsible for consumer protection and market integrity

Banking Act (1959)

- Bank must be authorised
- Depositor priority – depositors have first claim on the Australian assets of an insolvent bank
- Bank mergers require treasurers approval

Financial Sector (shareholdings) Act (1998)

- Maximum shareholding (15% unless approved by treasurer)

Four Pillars Policy

- Since 1990, the Australian government has precluded mergers between the major financial institutions. This is currently known as the Four Pillar policy and applies to mergers between the ANZ, CBA, NAB, and Westpac.
- The government has promised to allow such mergers but only when banking competition was sufficient, particularly in consumer and small business finance.
- In June 2008, the then Treasurer confirmed no change was planned for the Four Pillars policy.

Why Regulate Banks?

- Reduce systematic risk
    - Prevent panic and bank runs due to contagion
    - Contribute to the efficient flow of funds
    - Support the payments system
    - Provide a conduit for monetary policy
- Protect Consumers
    - Safety of deposits and clients are treated fairly
- Reduce moral hazard
    - Moral hazard = banks take more risk because they are protected and market discipline is weak

APRA Prudential Standards

- Prudential regulation refers to requirements or standards designed to limit the risk taking of banks with a view to ensuring the safety of depositors funds and the stability of the financial system

"APRA's core mission is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial