Topic 1

Financial Institutions and Credit Risk Analysis

Why are banks or financial institutions special?

- Brokerage function:
  1. Full services securities firm
     - Act as an agent by providing information and transaction services
     - Carry out investment research and make investment recommendation
     - Conduct the sale and purchase of securities for a commission and fee

     → provide advisory services
  2. Discount broker
     - Carry out the sale or purchase of securities at better price and with greater efficiency than household savers could achieve by trading on their own

     → only provide transaction services
- Asset transformer:
  - Issue their own securities, such as deposits, insurance policies, that are attractive to household savers
  - Using the proceeds to purchase the primary securities of corporations

- Reduce information cost
  - One problem faced by an average household saver directly investing in a commercial firm’s financial claims is the high cost of information collection.
  - Household savers must monitor the actions of firms in a timely manner and complete fashion after purchasing securities.
  - Failure to do so could lead to the risk that the firm’s owners or managers will take actions with the saver’s money contrary to the promises contained in the covenants of its securities contracts.
  - By putting excess funds into financial institutions, household savers give to the FIs the responsibility of deciding who should receive the money and of ensuring that the money is used properly by the borrower.
  - In this sense, investors have delegated the FIs to act as a monitor on their behalf.
  - Further, the FI can collect information more efficiently than individual investors. The FI can utilize this information to create new products, such as commercial loans, that continually update the information pool.
  - This frequent monitoring process sends important informational signals to other participants in the market, a process that reduces information imperfection and asymmetry between the ultimate providers and users of funds in the economy.

- Reduce the liquidity risk and price risk
    - Liquidity risk occurs when savers cannot sell their securities on demand. Commercial banks, for example, offers deposits that can be withdrawn at any time. Yet, the banks make long-term loans or invest in illiquid assets because they are able to diversity the portfolios and better monitor the performance of firms that have borrowed or issued securities. Thus, individual investors are able to realize the benefits of investing in primary assets without accepting the liquidity risk of direct investment.
- Reduce transaction costs
    - FIs can provide economies of scale in transaction costs because assets are purchased in larger amounts. By pooling assets of many small investors, FIs can gain economies of scale in transaction costs. This benefits occur whether the bank is lending to a corporation or retailed customer, and purchasing the assets in the money and capital markets. In either case, operational activities that are designed to deal in large volume typically are more efficient that those activities designed for small volume.

Reasons to regulate banks

1. Reduce systemic risk
   - Systemic risk occurs when bank failures are potentially contagious, so that the losses of a bank cascade into other banks, or other economies throughout the world.
   - The 'spread of failure' is called contagion
2. Protect against moral hazard
   - Moral hazard is where a party is insulated from risks behaves differently to the way they would behave if they were not insulated.
3. Protect consumers and pursue social goals

Identify and explain three economic disincentives that might be detrimental to flow of funds in the economy without financial institutions

- Monitoring costs. Monitoring the activities of borrowers requires extensive time, expenses, and expertise. As a result, households would prefer to leave this activity to others, and by definition, the resulting lack of monitoring would increase the riskiness of investing in corporate debt and equity markets.
- Liquidity costs. The long-term nature of corporate debt and equity securities would likely eliminate at least a portion of those households willing to lend money, as the preference of many for near-cash liquidity that dominates extra returns which may be available.
- Price risks. The price risks of transactions on the secondary markets would increase without information flows and services generated by high volume.

Topic 2

The Monetary Authorities

Regulatory framework includes 3 agencies:

- Reserve Bank of Australia (RBA): has the responsibility of monetary policy and for overall financial system stability
- Australian Prudential Regulation Authority (APRA): has the responsibility of prudential regulation and supervision of financial institutions
- Australian Investment and Securities Commission (ASIC): has the responsibility for market integrity and consumer protection across the financial system

Reserve Bank of Australia

- Primary functions:
    1. Determine and implement monetary policy
    2. Issue Australian currency notes
    3. Oversee and facilitate the payment system: efficient, effective, stable, competitive → maintain financial system stability
    4. Act as the government banker and issue securities on its behalf
    5. Issue and provide the markets for Commonwealth Treasury securities
    6. Manage financial system liquidity
    7. Manage the government's holding of foreign currency
- Statutory functions: (objectives of monetary policty)
    1. Stability of currency
    2. The maintenance of full employment
    3. The economic prosperity and welfare of the people in Australia
- Inflation control and steady economic growth are considered the most important goals

Australian Prudential Regulation Authority (APRA)

- APRA is controlling excessive risk-taking of the FIs
- Functions:
  1. Development and implementation of prudential regulation that all supervised entities will have to abide by
  2. Monitoring the regulated entities to ensure that they are complying with the relevant legislation and prudential policies. This includes the power to comply and remedy any non-compliances
  3. Advice government on the development of regulation and legislation affecting the related institutions and the financial markets in which they operate
- Why Prudential Regulation?
  - Curb excessive risk-taking incentives → improve the safety of depositor's funds → financial system stability → instil confidence in depositors and provide the basis for a strong economy

- Embedded option: lenders face addition risk due to options to repay loans and withdraw deposits early
- Duration gap: difference between effective time to recover the market price of an asset and a liability
- Repricing gap: a measure of the difference between the dollar value of assets that will reprice and the dollar value of liabilities that will reprice over a specific time period, where repricing can be the result of a rolled-over asset or liability (e.g. a loan is paid off at or prior to maturity and the funds are used to make a new loan at current market rates) or because the asset or liability is a variable rate instrument (e.g. a variable rate mortgage loan whose interest rate is reset every quarter bases on the movements in a prime rate).
- Rate sensitivity: represents the time interval where repricing can occur. This model focuses on the potential changes in net interest income variable.