Finance 561: FINANCIAL INTERMEDIATION

Professor: Rustom M. Irani
Class Time: Monday and Wednesday 11:00am – 12:20 pm
Class Location: 166 Wohlers Hall
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Office Hours: Wednesday 3:30 – 4:30 pm
Website: on compass2G

Course description

Both financial intermediaries and financial markets are essential components of a financial system and they interact with one another. This class has a focus on financial intermediaries with the objective to answer the following questions:

• What do financial intermediaries do?
• How and why are financial intermediaries are regulated?
• What types of risk do financial intermediaries face and how do they manage it?
• What is the role and impact of the central bank and its policy actions?

The emphasis will be on the risk management and regulation of U.S. commercial banks, but we will also provide an overview of other players in the market (hedge funds, mutual funds, insurance, credit unions, and so on).

Throughout the class we will use a number of case studies and examples to motivate the concepts we introduce. One important example that will be considered throughout is the global financial crisis of 2007-2009. We will consider failures of risk management prior to and during this period, as well as the regulatory response.

We will focus on applications of new concepts to real-world examples and data, rather than a purely theoretical treatment.
Course requirements

Class participation via discussion, questions, and contributions of examples from current events is required. Most of our class periods will be devoted to covering material from the textbook and other assigned readings, current financial and economic developments, and assignments and projects. A portion of your grade will depend on your contribution to the class discussion.

In addition, each student is required to make a brief current events presentation (no more than 10 minutes, please) of a topic relating to the subject matter of the course (financial intermediaries). Typically your presentation will relate to an article from a current business publication (e.g., the Wall Street Journal). On the day of your presentation you must email the instructor a scanned copy of the article you are using, as well as a copy of your presentation.

There will be a mid-term examination during the regular class meeting time on Monday, March 17. There will be a final examination on Friday, May 16. Reserve these dates since no make-up examinations will be provided without prior arrangement, in accordance with university policy.

There will be three written assignments during the semester. Two of these assignments will be set before the mid-term exam and one after. Your assignments will be graded on overall quality of presentation, effective writing, and proper grammar and punctuation. Take time to proofread and edit your work before submitting it.

Finally, as serious students of finance, I expect each of you to remain abreast of current developments in financial markets and financial institutions in general. One way to accomplish this is to read the Wall Street Journal or the New York Times daily. In addition, certain weekly publications like The Economist are useful for keeping up to date. These publications can be obtained at student (reduced) subscription rates.

Grading policy

- Class participation (10%)
- Three assignments (3 x 10 = 30%)
- Mid-term examination (25%)
- Final examination (35%)

Letter grades (+/-) will be assigned based on a curve.
Course textbook(s) and online resources

The lecture notes that I will provide in class are intended to be self-contained. The assignments and exams will be based on my lecture notes and discussion in class. I recommend these two additional readings to those students that want an alternative exposition:

   - Referred to as “Text”
   - Website for textbook: http://www.mhhe.com/saunders7e

   - Referred to as “Fed”
   - Available at: http://federalreserve.gov/pf/pf.htm

There are many excellent web sites containing information and/or data on financial intermediaries, financial markets, and information about the economy. A few of them are listed below, but you are encouraged to search the web for particular sites of interest to you.

- http://www.fdic.gov/ (individual bank and BHC data is here)
- http://www.occ.treas.gov/ (the national bank regulator)
- http://www.federalreserve.gov/ (the US central bank)
- http://www.stlouisfed.org/ (economic data at this Fed regional bank site)
- http://www.ffiec.gov/ (the coordinator agency for all bank regulators)
- http://www.bis.org (Basel capital regulation information is here)
- http://www.imf.org/ (International Monetary Fund)

Academic and professional integrity

Part 4 of the Student Code gives complete details of rules governing academic integrity for all students. You are responsible for knowing and abiding by these rules, which are available on the web at http://www.uiuc.edu/admin_manual/code/

You are expected to conduct yourself in a professional manner at all times in your dealings with the instructor and with other students in this class. In addition, professionalism must be demonstrated in class. Promptness and independent work on your assignments are also components of professionalism.
Course outline

I. The Structure and Regulation of Financial Intermediaries

No class: M (1/20)  Martin Luther King Holiday

Class 1: W (1/22)  Introduction

Class 2: M (1/27)  Direct finance and financial intermediation
Text:  Chapter 1

Class 3: W (1/29)  Depository financial intermediaries (DFIs)
Text:  Chapter 2

Class 4: M (2/3)  Non-deposit FIs—Pension funds and insurance companies
Text:  Chapter 3

Class 5: W (2/5)  Non-deposit FIs—Mutual and other funds and investment banks
Text:  Chapters 4 and 5

Class 6: M (2/10)  Regulation of depository FIs
Text:  Chapters 1, 2, 21, and Appendix 2C

Class 7: W (2/12)  Structural change in US banking and bank regulation
Text:  Chapter 21 and Appendix 21A

II. Measuring Risk in Financial Intermediaries

Class 8: M (2/17)  FI risks and performance evaluation
Text:  Chapter 7 and Appendices 2A and 2B

Class 9: W (2/19)  Interest rate risk: Interest flows and the WATM gap model
Text:  Chapter 8

Class 10: M (2/24)  Interest rate risk: Firm value and the duration gap model
Text:  Chapter 9 and Appendix 9B

Class 11: W (2/26)  Measuring market risk using value at risk (VAR)
Text:  Chapter 10 (pp. 283-296)

Class 12: M (3/3)  The lending process
Text:  Chapters 11 and 13 (pp. 404-411)

Class 13: W (3/5)  Credit risk assessment I
Text: Chapter 11 and Appendix 11A

Class 14: M (3/10) Credit risk assessment II
Text: Chapter 11 (pp. 349-352)

Class 15: W (3/12) Measuring liquidity risk
Text: Chapter 17

Class 16: M (3/17) Mid-term examination (in class, covering classes 1-15)

Class 17: W (3/19) Mid-term exam review

III. Managing Risk in Financial Intermediaries

Class 18: M (3/31) Liability and liquidity management
Text: Chapter 18 and Appendix 18A
Fed: Chapter 7

Class 19: W (4/2) Managing interest rate risk with futures and options
Text: Chapters 22 (pp. 696-713) and 23 (pp. 733-753)

Class 20: M (4/7) Managing interest rate risk with caps/floors/collars and swaps
Text: Chapters 23 (pp. 756-765) and 24 (pp. 774-784)

Class 21: W (4/9) Managing credit risk exposure for the bank
Text: Chapters 22 (pp. 720-723), 23 (pp. 754-756) and 24 (pp. 787-793), 25, and 26

Class 22: M (4/14) Managing credit risk exposure for the bank (cont.)

Class 23: W (4/16) Managing credit risk II: Measuring & covering loan losses

IV. Changes in Banking Industry Regulation

Class 24: M (4/21) Deposit insurance and the FDIC
Text: Chapter 19 and Appendices 19A and 19C

Class 25: W (4/23) Capital regulation and Basel
Text: Chapter 20

V. The Federal Reserve and Monetary Policy

Class 26: M (4/28) The Federal Reserve: Organization, goals, & tools
Fed: Chapters 1, 2 and Appendix A

Class 27: W (4/30) The Federal Reserve: Organization, goals, & tools (cont.)
Fed: Chapters 2 and 3

Class 28: M (5/5) The effects of Fed actions
Fed: Chapters 2 and 3

Class 29: W (5/7) Final exam review

| Final Examination | 8:00 to 11:00 a.m., Friday, May 16 |