Finance 461: Financial Intermediation
Fall 2009

1. **Instructor.** Morgan J. Lynge, Professor Emeritus of Finance.

   **Office hours.** My office is in 435 Wohlers Hall. I will have office hours 3:00 to 4:30 p.m. on Tuesday and Thursday or by appointment. When possible, please use these times to see me. If you cannot come during these office hours, make an appointment after class or by phone or e-mail for another time. I welcome your visits to my office for discussions on class material, current developments affecting financial institutions, or subjects of your choice.

   **Contact information.** You may always contact me by e-mail. My e-mail address is m-lynge@illinois.edu. E-mail inquiries will generally be answered within one business day. My office phone is (217) 333-7099.

2. **Course objectives.** Finance 461 is designed to complement Finance 300. Finance 300 has its focus on financial markets; Finance 461 examines financial intermediaries. Both financial intermediaries and financial markets are essential components of a financial system and they interact with one another. The objective of Finance 461 is to develop an understanding of:
   - The economic functions and roles of financial intermediaries;
   - How financial (risk) management functions in financial intermediaries;
   - How and why financial intermediaries are regulated and how this affects their management; and
   - The special role and impact of the central bank and its policy actions.

3. **Class meetings.** 8:00-9:20 Tuesday and Thursday in 3007 BIF.

4. **Class materials.**

   The Federal Reserve System: Purposes and Functions, Board of Governors of the Federal Reserve System, 2005 (Fed). I will provide this booklet to you free of charge.

   WEB REFERENCES: For certain topics, I will assign material that is available on the web. For this material I will provide a web address (Web).
5. Topic outline and reading assignments.

THE FINANCIAL SECTOR AND FINANCIAL INTERMEDIARIES

Class 1 (8/25)  Introduction to Finance 461
Class 2 (8/27)  Financial intermediaries (FIs)
                Text: Chapter 1
Class 3 (9/1)   Depository financial intermediaries (DFIs)
                Text: Chapter 2
Class 4 (9/3)   Non-deposit FIs—Insurance companies and pension funds
                Text: Chapter 3
Class 5 (9/8)   Non-deposit FIs—Mutual funds and investment banks
                Text: Chapters 4 and 5
Class 6 (9/10)  Non-deposit FIs—Finance companies
                Text: Chapter 6
                Bank or BHC selection for Bank Project due today
Class 7 (9/15)  Regulation of depository FIs
                Text: Chapters 1, 2, 21, and Appendices 2B and 7A (pp. 1-2)
Class 8 (9/17)  Structural change in banking
                Text: Chapters 21 and 22 and Appendix 21A
Class 9 (9/22)  FI risks and performance evaluation
                Text: Chapter 7 and Appendices 2A and 7A

MEASURING RISK IN FINANCIAL INTERMEDIARIES

Class 10 (9/24) Interest rate risk: Interest flows and the dollar gap model
                    Text: Chapter 8
                    Part A of Bank Project due today
Class 11 (9/29) Interest rate risk: Firm value and the duration gap model
                    Text: Chapter 9 and Appendix 9B
Class 12 (10/1)  Measuring market risk using VAR
Text: Chapter 10 (pp. 266-277)
Assignment #1 due today

Class 13 (10/6)  The lending process and credit risk
Text: Chapters 11 and 13 (pp. 380-386)

Class 14 (10/8)  Examination #1 on classes 1-12

Class 15 (10/13)  Credit risk assessment
Text: Chapters 11 and 13 (pp. 380-389)

Class 16 (10/13)  Measuring liquidity risk
Text: Chapter 17

MANAGING RISK IN FINANCIAL INTERMEDIARIES

Class 17 (10/20)  Liability and liquidity management
Text: Chapter 18
Fed: Chapter 7

Web: Rosen, “Role of Securitization . . .”

Class 19 (10/27)  Managing interest rate risk with futures and options
Text: Chapters 23 (pp. 691-708) and 24 (pp. 728-748)

Class 20 (10/29)  Managing interest rate risk with caps/floors/collars and swaps
Text: Chapters 24 (pp. 751-760) and 25 (pp. 769-777)
Part B of Bank Project due today

Class 21 (11/3)  Managing credit risk exposure for the bank
Text: Chapters 26 and 27

Class 22 (11/5)  Managing credit risk II
Text: Chapters 23 (pp. 716-720), 24 (pp. 749-751), and 25 (pp. 782-787)
Web: Neely, “High Loan Loss Reserves: Virtue or Vice?”
http://research.stlouisfed.org/publications/mt/19990301/cover.pdf
Assignment #2 due today
CHANGES IN THE BANKING INDUSTRY AND REGULATION

Class 23 (11/10) Deposit insurance and the FDIC
Text: Chapter 19

Class 24 (11/12) Examination #2 on classes 1-22

Class 25 (11/17) Capital regulation and Basel
Text: Chapter 20 and Appendix 20A

Class 26 (11/19) The Last Banking Crisis
Text: Chapters 19 and 20 (again) and Appendix 19A

FALL BREAK, NOVEMBER 21-29

CENTRAL BANKING AND MONETARY POLICY EFFECTS

Class 27 (12/1) The Federal Reserve and its goals
Fed: Chapters 1 and 2 and Appendix A
Part C of Bank Project due today

Class 28 (12/3) Monetary policy tools and operations
Fed: Chapter 2 (again) and 3

Class 29 (12/8) The effects of monetary policy
Fed: Chapters 2 and 3 (again)

Final Examination 8:00-11:00 a.m. Wednesday, December 16
6. **Basis for course grade.** The following components will enter into the computation of your semester grade for this course:

- **CLASS PARTICIPATION:** Most of our class periods will be devoted to covering material from the textbook and other assigned readings, current developments, and assignments and projects. Class participation via discussion, questions, and contributions of examples from current events is required. A portion of your grade will depend on your contribution to the class, either during class periods or through conferences with me.

In addition, each student is required to make a **brief presentation (no more than 5 minutes, please) of a current events topic** relating to the subject matter of the course. Most likely your presentation will be an article from a current publication of some sort. On the day of your presentation you must **provide me with a copy of the article you are using.**

I expect each of you, as serious students of finance, 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* daily. In addition certain weekly publications like *Forbes, The Economist,* and *Business Week* are useful for keeping up to date. See me for these and a variety of other business publications you can obtain at a student (reduced) subscription rate.

- **EXAMINATIONS:** There will be two examinations during regular class meeting times and a final examination at the end of the semester, which will be comprehensive. Reserve these dates since **no make-up examinations** will be provided without prior arrangement.
  
  Examination #1  Thursday, October 8 in class  
  Examination #2  Thursday, November 12 in class  
  Final Examination  8-11 a.m. Wednesday, December 16

- **ASSIGNMENTS:** There will be written assignments during the semester. These assignments will consist of:

  - **Short assignments.** There will be two written assignments during the semester. These assignments will take the form of problem sets.
  
  - **Bank project.** Each of you (or in a group of two) will perform a financial analysis of a specific commercial bank or bank holding company using the bank’s accounting data. More information on this project will be provided later. The project will be due in three stages during the semester.
- Due dates. All assignments and projects have due dates. In most cases I will allow a grace period until noon one day after the due date during which the assignment or project may be submitted without penalty. For example, if an assignment is due in class on a Thursday, the grace period will usually extend to noon on the following day (Friday). Work turned in after the grace period is over will be penalized for being late.

- OPTIONAL PAPER: If you wish to explore further some topic in the area of financial intermediaries, you may write a paper to accomplish this purpose. If you write a paper, the paper grade may be used to substitute for one of your examination grades during the semester (provided it is a higher grade), but not the final examination. This option is not provided so that you can choose to miss an examination. You must write your paper on a topic approved by me. Some guidelines are listed below. See me for more details.

- The paper must be no longer than 12 pages and must be typed (double spaced). Section headings, appropriate footnotes, and a good bibliography are required.
- You must submit an outline of your proposed topic to me for approval at any time, but no later than Thursday, November 19.
- Analysis is required in your paper. Empirical studies are preferred, and grades will generally be higher on well-done empirical studies.
- The paper is due at the final exam for Finance 461.

- GRADING: Your course grade will be determined using the following weights:

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<th>Component</th>
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<tr>
<td>Examination #1</td>
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<td>Examination #2</td>
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<td>Final Exam</td>
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<td>Assignments</td>
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<td>Bank project</td>
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<td>Class contribution</td>
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Plus (+) and minus (-) grades will be used in assigning semester course letter grades.
7. **Academic integrity**: The University statement on your obligation to maintain academic integrity is:

> If you engage in an act of academic dishonesty, you become liable to disciplinary action. Such acts include cheating; falsification or invention of any information or citation in an academic endeavor; helping or attempting to help others commit academic infractions; plagiarism; offering bribes, favors, or threats; academic interference; computer-related infractions; and failure to comply with research regulations.

Rule 33 of the Code of Policies and Regulations Applying to All Students 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/](http://www.uiuc.edu/admin_manual/code/).

8. **Professional integrity**: You are expected to conduct yourself in a professional manner at all times in your dealings with me and with other students in this class. In addition, professionalism must be demonstrated in your speaking and writing abilities in this class. Your assignments, especially your bank project, will always be graded on overall quality of presentation, effective writing, and proper grammar and punctuation. Take time to proofread and edit your documents before submitting them to me. Promptness and independent work are also components of professionalism.

9. **World wide web and financial intermediaries.** There are many excellent WWW sites containing information and/or data on financial intermediaries and markets. A few of them are listed below, but I encourage you to search the web for particular topics of interest to you.

   - [http://www.bis.org/](http://www.bis.org/)
   - [http://door.library.uiuc.edu/crx/](http://door.library.uiuc.edu/crx/)
   - [http://www.mhhe.com/saunders6e](http://www.mhhe.com/saunders6e) (web site for the textbook)

Besides the above web sites, most individual financial corporations (banks, bank holding companies, or financial holding companies) have their own web sites.