

BROWN UNIVERSITY  
DEPARTMENT OF ECONOMICS

## **FINANCIAL INSTITUTIONS**

Economics 176 Fall 2009

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Professor Ross Levine  
Office: Robinson 304C  
Telephone: 863-2170  
E-mail: [Ross\\_Levine@brown.edu](mailto:Ross_Levine@brown.edu)  
Class Website: @MyCourses  
Office Hours: W: 2-4, & by appointment

Section 01: Wilson 102, 1:00 – 2:20 TR  
Section 02: Wilson 302, 2:30 – 3:50 TR  
TAs and their Office Hours:  
Juan Carlos Gozzi, M: 9-11  
Ishani Tewari, R: 10-12

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### **COURSE DESCRIPTION**

EC176 analyzes the role of financial institutions in allocating resources, managing risk, and exerting corporate governance over firms. The class begins by studying interest rate determination, the risk and term structure of interest rates, the pricing of bonds, and how to manage interest rate risk. Special attention is given to the role of central banks in influencing interest rates. Next, the class uses economic principles to examine the emergence and impact of financial institutions on economic growth, income distribution, and financial stability. The class studies conflicts of interest in financial intermediaries, and extensively assesses the economics of regulation and the political forces shaping policy decisions. Besides familiarizing students with the operation and management of banks, mutual funds, insurance companies, pension funds, and investment banks, the class uses the economics of information to understand the functioning of financial institutions. An international perspective is stressed. Examples from countries with different legal, political, and regulatory regimes provide a richer understanding of the role of financial institutions than is possible by studying any single country. Prerequisites: EC 121

### **AIMS**

This course aims: (1) to provide you with the economic principles for understanding the emergence of financial institutions, their roles in shaping economic growth, business cycles, crises, and the distribution of income; (2) to familiarize you with and help you think critically about both the economic reasons for government regulation of financial institutions and the political forces shaping actual regulatory choices; and (3) to introduce you to the complexities and conflicts of interest associated with managing financial institutions. The class intends to provide an international perspective on the emergence, operation, impact, and regulation of financial institutions.

## OBJECTIVES

On completion of this course, students should be able to:

1. Calculate the impact of policy changes and events on interest rates.
2. Demonstrate how to manage the interest rate risk of financial institutions
3. Understand the economic principles underlying the emergence, evolution, and operation of financial institutions.
4. Assess reasons for and implications of conflicts of interest in financial institutions.
5. Describe how financial institutions affect resource allocation and economic activity.
6. Provide economic reasons for and against different regulations of financial institutions.
7. Evaluate the formation and efficacy of regulations under different political settings.

## DAILY ORGANIZATION

1. Lecture +:
  - Frequently start class with HO readings.
  - Lecture with many questions
2. “Socratic Days” – No lecturing. I just call on students randomly. These are voluntary. I will pre-announce the dates and material.

## ASSESSMENT

1. 0%: Quizzes. These quizzes provide guidance on what we need to review!
2. 10%: Class participation
  - Exceptional participation: you routinely volunteer good comments.
  - Satisfactory participation: you occasionally volunteer good comments.
  - *Unless frequently late or disruptive, class participation will not hurt your grade. This is a mechanism to reward students who truly make the semester exceptionally better for all of us.*
3. 25%: Exam #1 (Tentative Date: October 8<sup>th</sup>, 2009).
4. 35%: Exam #2 (Tentative Date: November 5<sup>th</sup>, 2009)
5. 30%: Exam #3 (Tentative Date: December 3<sup>rd</sup>, 2009)
  - Exam #2 is based primarily on material after Exam #1.
  - Exam #3 is based primarily on material after Exam #2.
  - Exam #3 is NOT a final exam.
  - I reserve the right to change the dates of the exams. So, please do not make end of semester travel plans based on Exam #3.
6. “Uncurved” letter grades: A: 87+, B: 77+, C: 67+.
  - You can think of the cut-offs as 90, 80, and 70 and I am nice.
  - Or, you can think of the cut-offs as 93, 83, and 73, and I am very nice.
  - Or, you can think of the cut-offs as 87, 77, and 67 and I am explicit.

## REQUIRED READINGS

(ME) *Financial Markets and Institutions*. 6<sup>th</sup> Edition. F. S. Mishkin and S.G Eakins, which is available at the bookstore. The outline lists required chapters.

(BCL) *Rethinking Bank Regulation: Till Angles Govern*. J. Barth, G. Caprio, and R. Levine, which is available at the bookstore. The outline lists required chapters.

(S) *Special Readings*. Various sources will augment the textbook. I will make them available through the class website. Special readings will be added as the class proceeds.

**Other:** Read the *Wall Street Journal*, *Financial Times*, the *Economist*, etc. First, if you are going to apply for jobs in finance, you must read the *WSJ*, *FT*, etc. starting last year. Second, a fun way to challenge the skills you are developing in the classroom is to apply them to current events. Third, if you read something related to the class that is useful, please share it with us!

## STUDYING FOR THIS CLASS

**Do the readings and attend lectures. Seek out the TAs if the material is difficult.** It is worth stating the obvious. Economics is fun, easy, and useful if taken in small doses. Trying to cram both the concepts and facts in short time periods will make the class a chore, difficult, and less rewarding.

**Do the quizzes:** Make sure you understand how to do the problems since they are designed to test whether you are achieving the objectives of the class.

**See the extra problems and old exams posted on the website.**

### Some boundaries:

- Although exam questions might be difficult, my goal is not to trick you.
- I will give you considerable guidance regarding “what you need to know.”

### Some hints:

- The first part of the class focuses on tools for understanding interest rates. This part involves the most (though not much) mathematics.
- The second part focuses on key economic principles, including adverse selection and moral hazard. Just like technological gadgets that are easy once you play with them, these concepts are intuitive - and widely applicable. Take time to think about them.
- The third part focuses on the economic and political forces underlying the regulation of financial institutions, and an overview of non-bank financial institutions. This will involve a large jump in the number of pages that you will have to read. Budget for this.

## COURSE OUTLINE\*

1. **Introduction** (September 10)  
ME Ch. 1&2            Why Study Finance? Overview (*light*)
  
2. **Basics of Interest Rate Management** (September 11, September 15 – 17)  
ME Ch. 3 (S)            What do Interest Rates Mean and what is Their Role in Valuation?  
ME Ch. 17              Banking and the Management of Financial Institutions (*light*)  
ME Ch. 24 (S)          The Management of Financial Institutions (pp. 624-636)
  
3. **Managing Rates in a Changing World** (September 22 - 29)  
ME Ch. 4 (S)            Why do Interest Rates Change?  
ME Ch. 5 (S)            Risk and the Term Structure of Interest Rates (pp. 99-108)
  
4. **Central Banks and Interest Rates** (September 30 - October 6)  
ME Ch. 7 (S)            Structure of Central Banks and the Federal Reserve System  
ME Ch. 8 (S)            Conduct of Monetary Policy (pp. 169-184; 203-204)  
ME Ch. 12                Mortgage Markets (*light*)  
S                            The Fed and the Crisis

<b>Exam #1</b>	<b>October 8<sup>th</sup> (tentative)</b>
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5. **Emergence, Impact, & Stability of Financial Institutions** (October 13 - 22)  
ME Ch. 15 (S)            Why do Financial Institutions Exist?
  
6. **Conflicts of Interest** (October 27 – October 29)  
ME Ch. 16 (S)            What Should be Done About Conflicts of Interest?
  
7. **Nonbanks** (November 3)  
  (ME Ch. 21) (S)        Mutual Fund Industry  
  (ME Ch. 22) (S)        Insurance and Pension Funds  
  (ME Ch. 23) (S)        Investment Banks, Securities Brokers/Dealers, and VCs

<b>Exam #2</b>	<b>November 5<sup>th</sup> (tentative)</b>
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8. **Structure of Regulation** (November 10 -12)  
ME Ch. 18 (S)            Commercial Banking Industry: Structure and Competition  
ME Ch. 20 (S)            Banking Regulation
  
9. **The Economics and Politics of Regulation** (November 17- December 1)  
BCL (S)                    Chapters 1, 2, 4, 5, 6 and Special readings

<b>Exam #3</b>	<b>December 3<sup>rd</sup> (tentative)</b>
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\* We WILL deviate from this schedule. Each class, I will note where we are in terms of the course outline.