

BROWN UNIVERSITY
DEPARTMENT OF ECONOMICS

FINANCIAL INSTITUTIONS

Economics 176 Fall 2011

Professor Ross Levine
Office: Robinson 304C
Telephone: 863-2170
E-mail: Ross_Levine@brown.edu
Class Website: @MyCourses
Office Hours: W: 2-4 & by appointment

Lecture: Smith-Buonanno Hall 106

TA and Office Hours:
Ana Tribin Uribe, Tu: 11-12
& by appointment
ana_tribin@brown.edu
Office: 70 Waterman, Room 208

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. The class uses examples from countries with different legal, political, and regulatory regimes to provide a richer understanding of the role of financial institutions than is possible by studying any single country. Prerequisites: EC1110 (or EC1130) and EC1210.

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.

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 financial regulations.
7. Evaluate the formation and efficacy of regulations under different political settings.

DAILY ORGANIZATION

1. Lecture “plus”:
 - The class frequently starts with reading a newspaper article.
 - I tend to ask lots of questions throughout lecture.
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.
2. 10%: Class participation
 - Exceptional participation: you routinely volunteer good comments.
 - Satisfactory participation: you occasionally volunteer good comments.
 - *Class participation will NOT hurt your grade. This is a mechanism to reward students who make the semester exceptionally better for all of us.*
3. 25%: Exam #1 (October 4th, 2011).
4. 35%: Exam #2 (November 3th, 2011)
5. 30%: Exam #3 (December 8th, 2010)
 - 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.
 - Tentative exam dates: 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*. 7th 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 8)
ME Ch. 1&2 Overview (*light*)

2. **Basics of Interest Rate Management** (September 13 - 20)
ME Ch. 3 (S) What do Interest Rates Mean and what is Their Role in Valuation?
ME Ch. 11 Money Markets (pp. 254 - 265) (*light*)
ME Ch. 12 The Bond Market (pp. 279 - 293) (*light*)
ME Ch. 13 The Stock Market (pp. 302 - 307) (*light*)
ME Ch. 17 Banking and the Management of Financial Institutions
ME Ch. 23 (S) Managing Interest Rate Risk (pp. 573 - 585)

3. **Managing Rates in a Changing World** (September 22)
ME Ch. 4 (S) Why do Interest Rates Change?
ME Ch. 5 (S) Risk and the Term Structure of Interest Rates (pp. 89 - 98)

4. **Central Banks and Interest Rates** (September 27 - 29)
ME Ch. 9 (S) Structure of Central Banks and the Federal Reserve System
ME Ch. 10 (S) Conduct of Monetary Policy
ME Ch. 14 Mortgage Markets (*light*)
S The Fed and the Crisis

Exam #1	October 4th (tentative)
----------------	---

5. **Emergence and Impact of Financial Institutions** (October 6 – 20)
ME Ch. 7 (S) Why do Financial Institutions Exist?

6. **Stability of Financial Institutions** (October 25 – October 27)
ME Ch. 8 (S) Why do financial crises occur?

7. **Structure of US Banking** (November 1)
ME Ch. 19 (S) Banking Industry: Structure and Competition

Exam #2	November 3rd (tentative)
----------------	--

8. **The Economics and Politics of Regulation** (November 8 – November 22)
ME Ch. 18 (S) Banking Regulation
BCL (S) Chapters 1, 2, 5, 6 and Special readings

9. **Nonbanks** (November 29 – December 6)
(ME Ch. 20) (S) Mutual Fund Industry
(ME Ch. 21) (S) Insurance and Pension Funds
(ME Ch. 22) (S) Investment Banks, Securities Brokers/Dealers, and VCs

Exam #3	December 8th (tentative)
----------------	--

* We WILL deviate from this schedule. Each class, I will note where we are in terms of the course outline.