

BROWN UNIVERSITY
DEPARTMENT OF ECONOMICS

FINANCIAL INSTITUTIONS

Economics 176

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Office Hours: W: 10-12, by appointment

Section 01: 1:00 – 2:20 TR
Section 02: 2:30 – 3:50 TR
TAs: Martin Goetz
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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, and their roles in pricing securities. Special attention is given to how central banks influence interest rates. We examine how to manage interest rate risks. 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.

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. Other students value your participation enormously.
 - Excellent participation: you volunteer good comments. Other students value your contributions.
 - Poor participation: you are late to class and do not positively contribute.
 - *I expect students to provide excellent participation. Excellent participation is consistent with an "A" grade. The exceptional participation category rewards students that truly make the semester extraordinarily better for all of us.*
 - "Socratic Days" – No lecturing. I just call on students randomly. I will pre-announce the dates and material.
3. 25%: Exam #1 (Tentative Date: October 4th, 2007).
4. 40%: Exam #2 (Tentative Date: November 8th, 2007)
5. 25%: Exam #3 (Tentative Date: December 13th, 2007)
 - 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 will not change the weighting of the exams.
 - I reserve the right to change the dates of the exams.
6. "Uncurved" letter grades: A: 87+, B: 77+, C: 67+.

REQUIRED READINGS

(ME) *Financial Markets and Institutions*. 5th 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. Financial institutions are changing all the time. A fun way to challenge the skills you are developing in the classroom is to apply them to current events. 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; also, seek out the TAs and attend their review sessions if the material is difficult: It is worth stating the obvious.

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 posted on the website.

Some boundaries:

- Although exam questions might be difficult, my goal is not to trick you.
- Although exam questions might be challenging, I will give you considerable guidance regarding “what you need to know.” If I have not given you problems on a topic or if I have not explicitly communicated that I am going to ask about a topic, you will not see that topic on exams.

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! - once you play with them. Take time to think about them.
- The third part focuses on the economic and political forces underlying the regulation of financial institutions. This part involves lots of reading. There is a LARGE jump in the number of pages that you will have to read. Budget for this.
- Then, we turn to a review of non-bank financial institutions, which also involves lots reading.

COURSE OUTLINE, LECTURE SCHEDULE, AND MAJOR READINGS

It is crucial that you keep up with the readings. 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. Below, I outline the course and list specific readings for each topic. I also provide a tentative schedule of when we will cover each particular subject. Since it is impossible to precisely plan in advance what we will cover day-by-day, we will definitely deviate from this schedule. During each class, I will make clear where we are in terms of the course outline. If you ever have questions, please ask.

1. Introduction (September 6)

- (ME Ch. 1) (S) Why Study Financial Markets and Institutions? (light)
 (ME) Ch. 2 Overview of the Financial System (light)

2. Basics of Interest Rate Management (September 11, September 18 – 20)

- (ME Ch. 3) (S) What do Interest Rates Mean and what is Their Role in Valuation?
 (ME Ch. 24) (S) The Management of Financial Institutions (pp. 622-629)

3. Managing Rates in a Changing World (September 25 - 27)

- (ME Ch. 4) (S) Why do Interest Rates Change?
 (ME Ch. 5) (S) Risk and the Term Structure of Interest Rates (pp. 101-111)

4. Central Banks and Interest Rates (October 2)

- (ME Ch. 7) (S) Structure of Central Banks and the Federal Reserve System
 (ME Ch. 8) (S) Conduct of Monetary Policy (pp. 176-205; 212-213)

Exam #1 **October 4th**

5. Emergence and Impact of Financial Institutions (October 9 - 25)

- (ME Ch. 15) (S) Why do Financial Institutions Exist?
 [Very lecture and special reading intensive]

6. Conflicts of Interest (October 30, November 6)

- (ME Ch. 16) (S) What Should be Done About Conflicts of Interest?
 [Very lecture and special reading intensive]

Exam #2 **November 8th**

7. Structure of Regulation (November 13-20)

- (ME Ch. 18) (S) Banking Industry: Structure and Competition
- (ME Ch. 20) (S) Banking Regulation

8. The Economics and Politics of Regulation (November 27-29)

- (BCL Ch. 1) Introduction
- (BCL Ch. 2) Approaches to Bank Regulation and Supervision
- (BCL Ch. 4) What Works Best? (light)
- (BCL Ch. 5) Choosing Bank Supervision and Regulation
- (BCL Ch. 6) Rethinking Bank Regulation and Supervision
- (S) Special readings on the website.

9. The Role, Management, and Regulation of Nonbanks (December 4-11)

- (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

Exam #3 December 13