**MBAD 6235 FINANCE**

**W1 GUIDELINE SOLUTIONS**

**FINANCIAL MARKETS & FINANCIAL SERVICE FIRMS**

**GUIDELINE SOLUTIONS ARE A VITAL PART OF THE TEACHING/LEARNING STRATEGY IN THIS COURSE.**

**STUDY THEM CAREFULLY!**

**SUBSEQUENT ASSIGNMENTS OFTEN DEPEND**

**ON PRIOR ASSIGNMENTS.**

**Week 1 Assignment Questions**

1. What are the necessary functions of financial markets?
2. Explain the essence of bank capital rules.
3. What is the connection between systemic risk and too-big-to fail?
4. Your boss asked you to make an elevator speech explaining Dodd-Frank to your colleagues. Write that speech. Facts only; no opinions!
5. As a member of Congress, would you support strong Dodd-Frank regulations or vote to repeal it? Would you support a return to Glass-Steagall? Explain fully.
6. Is the financial services industry (Wall Street, taken broadly, not just in New York City) closer to a bullshit business or a business doing God’s work? Explain fully.

***Remember what was said in the Syllabus about reading and digesting the weekly learning objectives and assignment questions. Focus your reading/study time accordingly: WORK BACKWARDS. Before*** *you start to read and study, examine the contents of this file. It offers study priorities, ranging from what is vital to what is for background and reference.*

**Q1 – What are the necessary functions of financial markets?**

**Grading Criteria:** 20 of 100 points

* Up to 15 for covering points a & d, depends on depth, quality
* Up to 5 for covering point b, mention of primary/secondary markets (anywhere in answer)
1. Vital purpose of financial markets is to ‘intermediate’ between surplus units and deficit units to marshal capital, facilitating trade and economic growth. The ‘intermediators’ are private for-profit businesses (commercial banks, investment banks, insurance companies, pension funds - not governmental agencies (FANNIE & FREDDIE are quasi-government exceptions).
2. Raising money (debt by governments, businesses, families – equity by businesses); the ‘primary’ market is the locus for newly issued securities
3. *Not in W1 readings, not expected in your essay: disintermediation is a major cause of the financial meltdown because of the huge size of weakly regulated non-banks (investment banks, insurance companies), regulation focused on commercial banks was marginalized. Further discussion to come.*
4. Provide liquidity to holders of securities, without which they would hesitate to invest, defined as the ease with which trading can be conducted in the secondary markets. Spreads between bid and asked prices are narrower in liquid markets. Wikipedia defines liquidity succinctly: “…an asset’s ability to be sold without causing a significant movement in price and with minimum loss of value.” This refers to ‘trading’ in the secondary markets where ‘exchanges’ take place.
5. Risk management through diversification.
6. Providing transparency – information available to investors about industries and companies (full disclosure) and access to price and trading data in secondary markets.
7. *Not much said in W1 Readings, not expected in your essay: setting prices for financial instruments consistent with their riskiness (default risk, liquidity risk, purchasing power risk). Further discussion to come.*

Mention of points a. and d. in sufficient detail hits the main points. Point b. can be viewed as a subset of point a. You should also mention the distinction between primary vs. secondary markets.

**Q2 - Explain the essence of bank capital rules.**

**Grading Criteria:** 15 of 100 points.

* 5 points for mention of asset side, numerator of equation
* 5 points for mention of equity side, denominator of equation
* up to 5 points for explanation of essence

Explanation of ‘essence’ does not require many words.

The essence of bank capital rules is to create a cushion for loss in value of bank assets (left side of balance sheet) with the capital (equity on the right side of the balance sheet). In times of stress (market crisis, weak economy) asset value may sharply decline. Capital must be adequate to absorb market value losses or write-downs in asset values (mark-to-market).

**Q3 – What is the connection between systemic risk and too-big-to fail?**

**Grading Criteria:** 20 of 100 points

* Up to 8 for clear understanding of systemic risk
* Up to 8 for clear understanding of too big to fail
* Up to 4 for explaining connections

You can tease out a definition from the systemic risk video. If you couldn’t watch the video, Wikipedia or Google offers plenty of information.

* The best definition from the video, paraphrased, is: a default in one (financial services company) triggering defaults in others – a chain reaction, a domino effect.
* The last one is good too: a shock to one agent is transmitted to other agents.
* In between, the definitions become more vague, wordy, pompous, almost worthless, as the video rolls on. Some caused me to laugh out loud! Did you?
* Financial services firms must be big enough to matter, or they don’t create systemic risk – which gets into too-big-to-fail, which leads to capital requirements, which leads to the Basel Accords, also mentioned on the systemic risk video.
* Too big to fail refers to financial services firms that are so large and interconnected that a failure of one will lead to a failure of many, i.e., systemic risk. They must be protected with a safety net of TARP-like bailout money so they do not fail, jeopardizing the entire economy.
* You could/should have made the connection between systemic risk and capital requirements, given the attention paid to it in the readings. Wk2 and beyond will develop it more. For now, it was enough to say that a high-enough level of capital (equity on the right side of its balance sheet) protects the bank from failing because it is a cushion against falling prices of assets on the left side of its balance sheet.

One the most valuable takeaways from MBAD 6235 will be your ability to visualize a business in terms of its financial statements, so start getting used to it.

“Suppose a bank wants to lend $100. To get the money it issues stock, borrows from other banks and money-market funds, takes deposits, or sells bonds. Under the old rules, a bank had to sell $3 of equity, and then it could borrow the remaining $97.

If the bank gets 6% interest on its loans, and pays 1% to its creditors, then the equity investors get $5 back for their $3 investment—a nice return. There's a risk of course: If some borrowers default and the loans only pay $97, the shareholders are wiped out.

But what if the loans only pay $90? Answer: Taxpayers fill the gap. The government guarantees deposits. Normally, the other bank creditors would split up the $90 in bankruptcy, but big banks are too big to fail these days.”

Please realize that systemic risk and too-big-to fail are two sides of the same coin. As the course continues, we will deal with the ‘moral hazard’ aspect of too big to fail which encourages these firms to take excessive risks knowing that they will be protected by bailouts, i.e., privatized gains & socialized losses.

**Q4 - Your boss asked you to make an elevator speech explaining Dodd-Frank to your colleagues. Write that speech. Facts only; no opinions!**

**Grading Criteria:** 15 of 100 points.

* 3 points each up to 15 points maximum for lucid discussion of at least five of the issues in parenthesis (elevator speech does not have to state the labels but must refer to them), minus 1 point for each generalization that do not no delve into specifics, minus 1 point for length beyond an elevator speech and/or poorly crafted answer
* Dodd-Frank was needed because increasingly weak bank regulation encouraged by effective lobbying and the growth of non-bank financial companies (shadow banks, disintermediation) allowed lending to unqualified (sub-prime) borrowers get out of control.
* Even weakened regulation does not work when these shadow banks exist outside the net of regulation.
* When borrowers defaulted, financial companies making the loans defaulted too, because they also over-borrowed (leverage), and did not have enough of their own capital to absorb losses (capital rules).
* The advent of giant banking conglomerates concentrated the danger of a nationwide or worldwide economic collapse because the failure of one bank causes failure of other banks (systemic risk, too-big-to-fail).
* Borrowed money that huge banks used to finance their day-to-day operations (liquidity) was no longer available, forcing the government to support them (TARP bailout) to avoid financial calamity. What they owed, liabilities, became larger than what they owned, assets (toxic securities), and they failed (insolvency).
* Dodd-Frank and its attendant regulations were written to re-regulate the banking system, strengthen capital requirements, deter excessive trading, and lessen too-big-to fail systemic risk.

**Q5 - As a member of Congress, would you support strong Dodd-Frank regulations or vote to repeal it? Would you support a return to Glass-Steagall? Explain fully.**

**Grading Criteria:** Total 15 of 100 points

* 1 point for specific support vs. repeal on Dodd-Frank
* Up to 2 points each = 8 points, for mention of any 4 themes in list to explain the ‘why’ of Dodd-Frank support or repeal
* 1 point for yes or no about return to Glass-Steagall
* Up to 5 points for explanation about Glass-Steagall

This is another open-ended query, asking you to display knowledge of Dodd-Frank’s content and intent and critique it any way you choose.

Dodd-Frank answer should cover some of the themes throughout W1 material:

1. consumer protection aspects of the legislation has little to do with the financial crisis (do you agree that consumers who took out sub-prime mortgages were not harmed?)
2. capture of regulators by bubble hysteria and lobbying push
3. insufficient capital available as a cushion against decline in value of assets
4. what do with Fannie & Freddie
5. fear of lending by banks retards the economy
6. shadow banking – disintermediation weakens impact of existing legislation
7. too much debt everywhere: business, government, families
8. ability of US banks to compete internationally could be limited by Dodd-Frank

Glass-Steagall answer should mention that Dodd-Frank has already limited ability of banks to engage in the securities business, namely the decline in profitability of trading and limits on proprietary trading. Hilary Clinton supports putting Glass-Steagall back as one measure for lessening the chance of other meltdown with too-weak bank regulation as a cause. Is reduction in trading by banks sufficient, i.e., does existence of Dodd-Frank eliminate the need for a new Glass-Steagall separating investment banking from commercial banking?

My view, to which to you do not have to agree, is that Dodd-Frank must be supported by Congress and strengthened. A return to Glass-Steagall, in the form of new legislation, may not be necessary if Dodd-Frank provisions and regulations remain strong and are not diluted by lobbying pressure.

**Q6 - Is the financial services industry (Wall Street, taken broadly, not just in New York City) closer to a bullshit business or a business doing God’s work? Explain fully.**

**Grading Criteria:** 15 of 100 points:

 15 points for a carefully crafted and thoughtful response

* judgmental
* taking a definite position and justifying it
* answer shows that W1 reading material was used
* minus 4 points if any of the three components above is missing or superficial or incomplete

I do believe, as my notes say, that the securities business is a BS business. But, it also does God’s Work because it marshals and moves capital so deficit units in the economy can raise debt and equity funds. Businesses can grow, add jobs, increase GDP. Families can borrow to buy cars and homes. So, it is BOTH.

My role is devil’s advocate to spur thinking and debate. Don’t interpret my view as a wholesale condemnation of the business – that’s not what I mean. This is not a value judgment. It’s called a market – bond market, stock market. Revenues come from selling something. Marketing is the name of the game – that’s not bad – products must be moved – deal flow must be maintained. The people who work in the financial markets have mortgage payments and children in school. Most firms are publicly-held; their stockholders expect performance. Government turns over the operation of financial markets to private, for profit firms even as they claim the august purpose of the financial markets is to ensure capital flows for economic growth. Have you seen the movie “Wolf of Wall Street? It is extreme. Penny-stocks are a backwater of this business – far from the main stream. But there IS carryover. It’s unmistakable that an element of BS exists.