

**University of California, Davis**  
**Graduate School of Management**  
MGB259: Banking and the Financial System  
Fall 2018

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<b>Instructor:</b>	Gregory Perelman	<b>Class Web site:</b>	class posted on Canvas
<b>Class Meetings:</b>	Saturdays (see GSM schedule)	<b>Contact e-mail:</b>	<a href="mailto:gperelman@ucdavis.edu">gperelman@ucdavis.edu</a>
<b>Office hours:</b>	by appointment		

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**Course Description:**

This course will analyze the main functions of financial institutions and review the recent developments in the financial services industry. We will examine the functions performed by incumbent players in the following segments: payment processing systems, extension of credit to businesses and consumers, money management, investment banking and securities trading; attention will then turn to new industry players within each segment - those companies that are using digital technologies and big data to disrupt traditional players' business models. Potential market size, product pricing and profitability of the new players will be evaluated.

It is assumed that students have good working knowledge of the basic theoretical and practical concepts of economics, accounting, and corporate finance. The course is intended not only for those interested in careers within financial institutions, but also for those who wish to extend their institutional and industry specific knowledge.

**Reading:** there is no textbook for this course – all of the required readings are provided in the textpak and listed in the course schedule

**Cases:**

1. The U.S. Banking Panic of 1933 and Federal Deposit Insurance (HBS Case #9-799-077: Rev. January 23, 2008).
2. Santa Fe Trading Company (link on class website)
3. Lending Club: Time to Join? (HBS Case #9-214-046), November 14, 2014
4. Betting on Failure: Profiting from Defaults on Subprime Mortgages (Case KEL880), Jan. 5, 2015
5. The Tip of the Iceberg: JP Morgan Chase and Bear Stearns (A), Nov. 21, 2011

**Notes:**

1. HBS #9-602-153: Economics of Retail Banking Note, Rev. March 24, 2006
2. HBS #9-209-107: An Introduction to Consumer Credit. February 20, 2009
3. HBS #9-291-026 Note on Bank Loans, Rev. October 29, 1993
4. #UV7393: Bitcoin: Investment or Illusion? Rev. Jan. 29, 2018
5. #UV7356: An Introduction to Blockchain, Rev. Dec. 7, 2017
6. HBS #9-310-131: Note: Disclosure, Regulations, and Taxation of Hedge funds versus Mutual funds in the U.S., Rev. May 18, 2012
7. HBS#9-902-168: History of Investment Banking, January 16, 2002
8. HBS #9-311-012: Note on the Insurance Industry, July 26, 2010

Other reading materials will be distributed in class or over the class web page.

**Course Format**

Lectures, class discussions, problem solving and case studies.

Due to the labor-intensive nature of case preparation, it is strongly recommended that students work in groups to get ready for class.

**Grading Policies:**

Individual participation:	10%
Group cases:	30%
Quizzes:	30%
Individual research project:	30%

**Class Participation**

This course is structured as a SEMINAR, which means you must come prepared for class discussions and actively participate in class to receive credit. If you expect to miss a class for any reason, send me an e-mail beforehand. In class discussions, entire groups may be asked to take stands and express their views on the case questions. At other times, individual students will be asked to do the same. Students can expect a mix of all approaches. Questions and discussions are encouraged throughout the course.

**Case Analysis (Groups)**

In this class you will work with a team of 3-4 students on five case studies. For each case, every team must submit the following:

- a) *Before class*: 3-4 page write-up in Word document (excluding exhibits) where you address case questions posted on the class website; Excel spreadsheet (for some of the cases – see class website for details);
- b) *After class*: (in 1-2 days after case discussion) one-page summary of the in-class discussion (address any issues that you might have missed in the pre-class write-up);

A few more comments on the write ups: no detailed background of the case is needed – a few lines will be sufficient. At the same time, do not assume that the reader knows every number in the case. The write up is a stand-alone document and should state major problems or opportunities facing the decision-maker, list alternative courses of actions and come up with specific recommendations. It is important to make your decisions given the available information provided within the cases. You are welcome to use outside sources, but, as in real life, you will never have complete information and unlimited time to make your decisions. If you make any assumptions, clearly state them. The write-up should be professional and addressed to the CEO/CFO as an internal or consulting report. Write in complete and grammatically correct sentences. Avoid bulleted presentations in the write ups.

Case grading will be based on both written submissions and on your group's participation in case discussions. The lowest score on the cases will be dropped in calculating the overall course grade.

**Quizzes**

We will have several quizzes during the course (open book/notes). No makeup quizzes or exams will be given, except as required by university policy. The lowest score on the quizzes will be dropped in calculating your course grade.

**Individual research project**

For your research project, you will pick one *new* company operating in one of the financial industry segments (credit, payments, money management, insurance, etc.); your paper will consist of three part: industry overview, company's business model, company's valuation; more details about the project will be provided in class discussions and on Canvas.

## TENTATIVE COURSE SCHEDULE

Weekend	Topics, readings, and assignments
1 Morning	<p>Financial institutions and their functions:</p> <ul style="list-style-type: none"> <li>✓ Financial intermediaries: maturity, liquidity and risk transformation; information asymmetry (adverse selection and moral hazard); screening and monitoring;</li> </ul> <p>Recommended reading:  Akerlof, George A., <i>"The Market for 'Lemons': Quality Uncertainty and the Market Mechanism."</i> Quarterly Journal of Economics, August 1970, 488-500.  <i>The Future of finance and the theory that underpins it.</i> London School of Economics, 2010. Chapter 1 – What do banks do?</p>
1 Afternoon	<p>Federal Reserve</p> <ul style="list-style-type: none"> <li>✓ Monetary policy</li> <li>✓ Fed funds rates</li> <li>✓ Yield curve</li> <li>✓ Other central banks</li> </ul> <p><b>Required readings:</b></p> <ul style="list-style-type: none"> <li>• <a href="#">Money in the modern economy: an introduction.</a> By Michael McLeay, Amar Radian and Ryland Thomas. Bank of England Quarterly Bulletin, 2014 Q1</li> <li>• <a href="#">Money creation in the modern economy.</a> By Michael McLeay, Amar Radia and Ryland Thomas. Bank of England Quarterly Bulletin, 2014 Q1</li> </ul> <p>Recommended reading:  Bernanke, Ben, S. <i>"Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression,"</i> The American Economic Review. June 1983, 237-276.</p>
2 Morning	<p>History of the U.S. banking industry</p> <ul style="list-style-type: none"> <li>✓ deposit insurance: arguments for and against</li> <li>✓ Finance industry regulations</li> </ul> <p><b>Case 1:</b> <i>The U.S. Banking Panic of 1933 and Federal Deposit Insurance</i>  <b>Assignment:</b> submit a write up where your group addresses all questions posted for this case on Camino</p> <p>Recommended reading:  <a href="#">Why Did FRD's Bank Holiday Succeed?</a> By WL Silber. Economic Policy Review, New York Federal Reserve, July 2009, Volume 15, Number 1</p>
2 Afternoon	<p>Measuring financial performance of financial intermediaries;</p> <ul style="list-style-type: none"> <li>✓ balance sheet and income statement analysis</li> <li>✓ Revenue and profit of key business components: <ul style="list-style-type: none"> <li>○ deposits and payments</li> <li>○ lending</li> <li>○ wealth management and other businesses</li> </ul> </li> <li>✓ ROE decomposition analysis and regulation of capital</li> </ul> <p><b>Required reading:</b></p> <ul style="list-style-type: none"> <li>• (textpak) HBS, #9-602-153: Economics of Retail Banking Note. Rev. March 24, 2006</li> <li>• (textpak) HBS #9-209-107: An Introduction to Consumer Credit. February 20, 2009</li> <li>• <a href="#">Stress testing of banks: an introduction.</a> By Kleran Dent and Ben Westwood. Bank of England Quarterly Bulletin, 2016 Q3</li> </ul>

	<ul style="list-style-type: none"> <li>• <a href="#">Bank capital and liquidity</a>. By Marc Farag and Damian Harland. Bank of England Quarterly Bulletin, 2013 Q3</li> </ul> <p>Recommended reading:  <a href="#">Bank funding costs: what are they, what determines them and why do they matter?</a>  Bank of England, Quarterly Bulletin, Q3, 2014</p>
3 Morning	<p>Traditional lending and product pricing:</p> <ul style="list-style-type: none"> <li>✓ Current bank lending practices</li> <li>✓ Pricing of traditional banking products</li> <li>✓ Credit scoring</li> </ul> <p><b>Case 2:</b> <i>Santa Fe Trading Company</i>  <b>Assignment:</b> submit group case write up where you address all questions listed at the end of the case; include Excel spreadsheet with your work;</p> <p><b>Required reading:</b></p> <ul style="list-style-type: none"> <li>• (textpak) HBS #9-291-026 Note on Bank Loans, Rev. October 29, 1993</li> </ul>
3 Afternoon	<p>Innovations in lending and alternative finance</p> <ul style="list-style-type: none"> <li>✓ Big data and new loan underwriting techniques</li> <li>✓ Marketplaces and alternative lenders</li> <li>✓ Economics of alternative lenders</li> </ul> <p><b>Case 3:</b> Lending Club: Time to Join?  <b>Assignment:</b> submit a write up where you address questions posted on Canvas;</p> <p>Suggested reading:  LendingClub Inc.: Research Note</p>
4 Morning	<p>Payment function: from the bill of exchange to Visa/MasterCard to Bitcoin:</p> <ul style="list-style-type: none"> <li>✓ history: medieval fairs and bills of exchange, metallic money, gold standard</li> <li>✓ economics of modern payment systems: checks in the U.S.; economics of credit cards, merchant services;</li> <li>✓ bitcoin</li> <li>✓ economics of challengers - estimating market potential and expected financial performance</li> </ul> <p><b>Required reading:</b></p> <ul style="list-style-type: none"> <li>• (textpak) #UV7393: Bitcoin: Investment or Illusion? Rev. Jan. 29, 2018</li> <li>• (textpak) #UV7356: An Introduction to Blockchain, Rev. Dec. 7, 2017</li> <li>• Innovations in payment technologies and the emergence of digital currencies. By Robleh Ali, John Barrdear, Roger Clews and James Southgate Bank of England Quarterly Bulletin, 2014 Q3</li> <li>• The economics of digital currencies. By Robleh Ali, John Barrdear, Roger Clews and James Southgate. Bank of England Quarterly Bulletin, 2014 Q3</li> </ul> <p><a href="#">Link to both BoE papers</a></p> <p>Suggested reading:</p> <ul style="list-style-type: none"> <li>• <a href="#">How has cash usage evolved in recent decades?</a> What might drive demand in the future? By Tom Fish and Roy Whymark, Bank of England Quarterly Bulletin, 2015 Q3</li> <li>• <a href="#">The global role of the US dollar and its consequences</a>. Fernando Eguren Martin, Mayukh Mukhopadhyay and Carlos van Hombeeck, Quarterly Bulletin 2017 Q4</li> </ul>

<p>4 Afternoon</p>	<p>Investment and money management – history and innovations</p> <ul style="list-style-type: none"> <li>✓ history of financial instruments and stock exchanges (New York, London,)</li> <li>✓ money management: mutual funds, retirement funds;</li> <li>✓ speed trading: economics, efficiency and fairness;</li> <li>✓ innovations in money management business ('robo advisors,' etc.)</li> </ul> <p><b>Case 4:</b> Betting on Failure: Profiting from Defaults on Subprime Mortgages (Case KEL880)</p> <p><b>Assignment:</b> submit a write up where you address questions posted on Canvas; include Excel spreadsheet with your work;</p> <p>Required reading:</p> <ul style="list-style-type: none"> <li>• (textpak) HBS #9-310-131: Note: Disclosure, Regulations, and Taxation of Hedge funds versus Mutual funds in the U.S., Rev. May 18, 2012</li> </ul>
<p>5 Morning</p>	<p>Review of insurance industry Review of investment banking industry</p> <p><b>Required reading:</b></p> <ul style="list-style-type: none"> <li>• (textpak) HBS #9-311-012: Note on the Insurance Industry, July 26, 2010</li> <li>• <a href="#">Insurance and financial stability</a>. By Andrea French and Mathieu Vital, Bank of England Quarterly Bulletin, 2015 Q3</li> <li>• (textpak) HBS#9-902-168: History of Investment Banking, January 16, 2002</li> <li>• <a href="#">Investment banking: linkages to the real economy and the financial system</a>. By Kushal Balluck, Bank of England Quarterly Bulletin, 2015 Q1</li> </ul>
<p>5 Afternoon</p>	<p>Investment banks, money market mutual funds and the shadow banking system</p> <ul style="list-style-type: none"> <li>✓ securitization</li> <li>✓ credit default swaps and other innovations in financial products</li> <li>✓ innovation in finance vs. systemic risk</li> <li>✓ TARP</li> </ul> <p>Post crisis environment in financial industry: regulation vs. innovation Course review and Q&amp;A session</p> <p><b>Case 5:</b> <i>The Tip of the Iceberg: JP Morgan Chase and Bear Stearns (A)</i>, 2009</p> <p><b>Assignment:</b> submit a write up where you address questions posted on Camino; include Excel spreadsheet with your work;</p> <p>Suggested reading:</p> <ul style="list-style-type: none"> <li>• <a href="#">Bank failure and bail-in: an introduction</a>. By Lucy Chennels and Venetia Wingfield. Bank of England Quarterly Bulletin, 2015 Q3</li> <li>• John Kay, <i>Other People's Money</i>, 2015</li> <li>• Robert Shiller, <i>Finance and the Good Society</i>, 2012</li> </ul>