Chapter 1 Why are financial institutions special?

Chapter outline

Financial institutions' specialness
- FI function as broker
- FI function as asset transformer
- Information costs
- Liquidity and price risk
- Other special services

Other aspects of specialness
- The transmission of monetary policy
- Credit allocation
- Intergenerational wealth transfers or time intermediation
- Payment services
- Denomination intermediation

Specialness and regulation
- Safety and soundness regulation
- Monetary policy regulation
- Credit allocation regulation
- Consumer and investor protection regulation
- Entry regulation

The changing dynamics of specialness
- Trends in Australia
- Global trends
- The rise of financial services holding companies

The shift away from risk measurement and management and the global financial crisis

Appendix 1A: The US sub-prime crisis, the global financial crisis and the failure of financial services institution specialness
Appendix 1B: Implementation of monetary policy by the Reserve Bank of Australia

Learning objectives

1.1 Understand why financial institutions (FIs) are different from commercial firms (which is why, for example, the failure of a large bank may have more serious effects on the economy than the failure of a large steel or car producer).
1.2 Learn how financial institutions—especially banks—provide a special set of services to households and firms.
1.3 Discover why FIs' very specialness results in increased regulation and regulatory oversight that other corporations do not require, which imposes a regulatory burden on financial institutions.
1.4 Gain knowledge of how regulation can and does affect the efficiency with which financial institutions produce financial services.
1.5 Understand how the failure of FIs to perform the specialist functions of risk measurement and management can lead to systemic risk in the domestic and global financial systems.
1.6 Comprehend the causes of the sub-prime crisis in the US and how this led to the global financial crisis.

Overview of chapter

The major theme of this book is the measurement and management of the risks of financial institutions (FIs). Although we might categorise or group FIs and label them 'life insurance companies', 'banks', 'finance companies' and so on, the particular risks that they face are more common than different. Specifically, all the FIs described in this chapter (1) hold some assets that are potentially subject to default or credit risk and (2) tend to mismatch the

maturities of their balance sheets to a greater or lesser extent and are thus exposed to interest rate risk. Moreover, all are exposed to some type of underwriting risk, whether through the sale of securities or by issuing various types of credit guarantees on or off the balance sheet. Finally, all are exposed to operating cost risks because the production of financial services requires the use of real resources and back-office support systems.

This chapter describes the various factors and forces impacting FIs and the specialness of the services they provide. These forces suggest that in the future, FIs that have historically relied on making profits by performing traditional special functions—such as asset transformation and the provision of liquidity services—will need to expand into selling financial services that interface with direct security market transactions, such as asset management, insurance and underwriting services. This is not to say that specialised or niche FIs cannot survive, but rather that only the most efficient FIs will prosper as the competitive value of a specialised FI charter declines.

Because of these risks and the special role that FIs in particular play in the financial system, FIs are singled out for special regulatory attention. In this chapter, we first examine questions related to this specialness. In particular, what are the special functions that FIs—both depository institutions (banks, building societies and credit unions) and non-depository institutions (insurance companies, securities brokers, investment banks, finance companies and managed funds)—provide? How do these functions benefit the economy? Second, we investigate what makes some FIs more special than others. Third, we look at how unique and long-lived the special functions of FIs really are. As a part of this discussion, we briefly examine how changes in the way FIs deliver services played a major part in the events leading up to the global financial crisis (GFC), commencing in the late 2000s. A more detailed discussion of the causes of major events during and regulatory and industry changes resulting from the financial crisis is provided in Appendix 1A to the chapter. Appendix 1B describes the way the RBA decides and carries out monetary policy in Australia.

Chapter 1 Teaching Suggestions

This chapter is very useful to commence any course on financial institutions management or bank management. Or indeed any course which examines regulatory structures and the reasons for them.

One way to commence the topic is to ask the question ‘Why are the banks, or more generally, the financial services industry, so heavily regulated?’ One of the answers to this question is the special nature of the financial institutions and the role that they play in the transition of money in the economy—and the transmission of government policy (both fiscal and monetary). A follow-up question could be ‘why do we have a course specifically on the management of banks/FIs—that is, why are they different from other businesses?’ This question allows the development of a discussion of the specific products, the interaction with customers—that is, the facilitation of business through financial transactions, etc., and the role of FIs in enabling business to take place. It also allows for a discussion of the ways that FIs affect the economy as a whole and not just a specific part (such as manufacturing).

From here, it is possible to develop a discussion of the economy with and without banks—and the role of intermediation in assisting commerce, and from this develop the discussion of the various functions of FIs which are useful.

For example, ask students to think about the different roles that FIs may undertake which assist business activity:

1. Monitoring function
2. Intermediation
    a. Liquidity intermediation

b. Currency intermediation
c. Time intermediation
d. Asset intermediation
e. Risk intermediation

3. Transmission of monetary policy and role in funding for fiscal policy through purchase and sale of government bonds
4. Credit allocation mechanisms
5. Payment system and the transmission of payments generally

As each of these points arise in the discussion, the lecturer can expand on each and provide examples from their own experience and draw on the experience of students to bring the topic alive. Encouraging students to see the relevance of this discussion to their own lives at this point in the subject will assist you in making the important point about the need for conservative management of FIs—to protect our savings and future financial health and capability—and more generally, to protect the future underlying financial security of the Australian economy.

It is important to set the tone for the subject in this introductory lecture, using Chapter 1, as by capturing the imagination of students through their own experience and expression, they will better understand why the identification of risks in FIs is so important, as of course is the management of those risks.

From an understanding of the role of FIs' various functions, and their impact on the economy, it is an easy step to argue why FIs are regulated. You may like to ask some questions about potential scenarios such as:

1. What would happen if you couldn't withdraw your money from the bank?
2. What would happen if none of the banks would lend to you to buy a house?
3. What would happen if the banks would not lend to small businesses?
4. What would happen if you had to wait two weeks to withdraw your funds?
5. What would happen if you could only withdraw US dollars, and not Australian dollars?
6. What would happen if you could only use cheques and these are only cleared on a weekly basis?
7. What if my bank deposits were not safe?
8. What if all of my bank's deposits were invested in high risk entrepreneurial activities?
9. Who can open and bank—or what businesses can call themselves a bank?

From these types of questions, you can then discover through discussion of the issues involved, the types of regulation that may be useful, so that a set of main types of regulations are identified:

1. Safety—capital and liquidity regulation
2. Monetary policy regulation
3. Credit allocation regulation
4. Consumer protection regulation

5. Investor protection regulation
6. Entry and chartering regulation

Throughout the discussion, you should emphasise the risks faced by FIs and the importance of their management. The fact that much of the regulation of FIs is towards the limit on risk taking is a particularly important point.

The changing structure and dynamics of the FI firm in the modern global financial markets should also be examined through a discussion of the modern versus the traditional product type FI: that is, now we have FI conglomerates/holding companies which provide all types of financial services, whereas only 30 years ago, we had banks, insurance companies, fund managers, etc., each providing one type of service. The Australian and global trends are telling, and this could lead to a discussion of how the changing structure of FIs may have changed the effectiveness of risk management within these FIs. You may also wish to discuss in more detail the role of this particular issue in the causes and consequences of the global financial crisis of the late 2000s—a great case study, and which is the subject of Appendix 1A. Depending on the subject curriculum, the next chapter covered could be either Chapters 2 and 3 (which describe the institutional characteristics of depository institutions and other FIs) or Chapter 4, which introduces students to the key financial risks faced by FIs.

Answers to end-of-chapter questions

Questions and problems

1 What are five risks common to financial institutions? **LO 1.1**

Default or credit risk of assets; interest rate risk caused by maturity mismatches between assets and liabilities; liability withdrawal or liquidity risk; underwriting risk; and operating cost risks.

2 Explain how economic transactions between household savers of funds and corporate users of funds would occur in a world without FIs. **LO 1.1, 1.2**

In a world without FIs, the users of corporate funds in the economy would have to approach the household savers of funds directly in order to satisfy their borrowing needs. This process would be extremely costly because of the upfront information costs faced by potential lenders. Cost inefficiencies would arise with the identification of potential borrowers, the pooling of small savings into loans of sufficient size to finance corporate activities and the assessment of risk and investment opportunities. Moreover, lenders would have to monitor the activities of borrowers over each loan's life span. The net result would be an imperfect allocation of resources in an economy.

3 Identify and explain three economic disincentives that probably would dampen the flow of funds between household savers of funds and corporate users of funds in an economic world without FIs. **LO 1.2**

Investors generally are averse to purchasing securities directly because of (a) monitoring costs, (b) liquidity costs and (c) price risk. Monitoring the activities of borrowers requires extensive time, expense and expertise. As a result, households would prefer to leave this activity to others and, by definition, the resulting lack of monitoring would increase the riskiness of investing in corporate debt and equity markets. The long-term nature of corporate equity and debt would likely eliminate at least a portion of those households willing to lend money, as the preference of many for near-cash liquidity would dominate the extra returns that may be available. Third, the price risk of transactions on the secondary markets would increase without the information flows and services generated by high volume.

4 Identify and explain the two functions in which FIs may specialise that enable the smooth flow of funds from household savers to corporate users. **LO 1.1, 1.2**

FIs serve as conduits between users and savers of funds by providing a brokerage function and by engaging in the asset transformation function. The brokerage function can benefit both savers and users of funds and can vary according to the firm. FIs may only provide transaction services—such as discount brokerages—or they also may offer advisory services which help reduce information costs, such as full-line firms like Merrill Lynch. The asset transformation function is accomplished by issuing their own securities, such as deposits and insurance policies that are more attractive to household savers and using the proceeds to purchase the primary securities of corporations. Thus, FIs take on the costs associated with the purchase of securities.

5 In what sense are the financial claims of FIs considered *secondary securities*, while the financial claims of commercial corporations are considered *primary securities*? How does the transformation process, or intermediation, reduce the risk, or economic disincentives, to the savers? **LO 1.2**

The funds raised by the financial claims issued by commercial corporations are used to invest in real assets. These financial claims, which are considered primary securities, are purchased by FIs whose financial claims are therefore considered secondary securities. Savers who invest in the financial claims of FIs are indirectly investing in the primary securities of commercial corporations. However, the information-gathering and evaluation expenses, monitoring expenses, liquidity costs and price risk of placing the investments directly with the commercial corporation are reduced because of the efficiencies of the FI.

6 Explain how FIs act as delegated monitors. What secondary benefits often accrue to the entire financial system because of this monitoring process? **LO 1.2**

By putting excess funds into FIs, individual investors give to the FIs the responsibility of deciding who should receive the money and of ensuring that the money is utilised properly by the borrower. In this sense the depositors have delegated the FI to act as a monitor on their behalf. The FI can collect information more efficiently than individual investors. Further, the FI can utilise this information to create new products, such as commercial loans, that continually update the information pool. This more frequent monitoring process sends important informational signals to other participants in the market, a process that reduces information imperfection and asymmetry between the ultimate sources and users of funds in the economy.

7 What are five general areas of FI specialness that are caused by providing various services to sectors of the economy? **LO 1.2**

First, FIs collect and process information more efficiently than individual savers. Second, FIs provide secondary claims to household savers which often have better liquidity characteristics than primary securities such as equities and bonds. Third, by diversifying the asset base FIs provide secondary securities with lower price–risk conditions than primary securities. Fourth, FIs provide economies of scale in transaction costs because assets are purchased in larger amounts. Finally, FIs provide maturity intermediation to the economy, which allows the introduction of additional types of investment contracts, such as mortgage loans, that are financed with short-term deposits.

8 What are agency costs? How do FIs solve the information and related *agency costs* when household savers invest directly in securities issued by corporations? What is the 'free-rider' problem? **LO 1.2**

Agency costs occur when owners or managers take actions that are not in the best interests of the equity investor or lender. These costs typically result from a failure to adequately monitor the activities of the borrower. Because the cost is high, individual investors may do an incomplete job of collecting information and monitoring under the assumption that someone else is doing these tasks. In this case, the individual becomes a free rider. But if no other lender performs these tasks, the lender is subject to agency costs as the firm may not satisfy the covenants in the lending agreement. Because the FI invests the funds of many small savers, the FI has a greater incentive to collect information and monitor the activities of the borrower.

9 How do large FIs solve the problem of high information collection costs for lenders, borrowers and financial markets in general? **LO 1.2**

One way FIs solve this problem is that they develop secondary securities that allow for improvements in the monitoring process. An example is the bank loan that is renewed more quickly than long-term debt. The renewal process updates the financial and operating

information of the firm more frequently, thereby reducing the need for restrictive bond covenants that may be difficult and costly to implement.

10 How do FIs alleviate the problem of liquidity risk faced by investors who wish to invest in the securities of corporations? **LO 1.2**

Liquidity risk occurs when savers are not able to sell their securities on demand. Banks, for example, offer deposits that can be withdrawn at any time. Yet the banks make long-term loans or invest in illiquid assets because they are able to diversify their portfolios and better monitor the performance of firms that have borrowed or issued securities. Thus individual investors are able to realise the benefits of investing in primary assets without accepting the liquidity risk of direct investment.

11 How do FIs help individual savers diversify their portfolio risks? Which type of financial institution is best able to achieve this goal? **LO 1.2**

Money placed in any FI will result in a claim on a more diversified portfolio. Banks lend money to many different types of corporate, consumer and government customers, and insurance companies have investments in many different types of assets. Investment in a mutual fund may generate the greatest diversification benefit because of the fund's investment in a wide array of stocks and fixed-income securities.

12 How can FIs invest in high-risk assets with funding provided by low-risk liabilities from savers? **LO 1.2**

Diversification of risk occurs with investments in assets that are not perfectly positively correlated. One result of extensive diversification is that the average risk of the asset base of an FI will be less than the average risk of the individual assets in which it has invested. Thus individual investors realise some of the returns of high-risk assets without accepting the corresponding risk characteristics.

13 How can individual savers use FIs to reduce the transaction costs of investing in financial assets? **LO 1.2**

By pooling the assets of many small investors, FIs can gain economies of scale in transaction costs. This benefit occurs whether the FI is lending to a corporate or retail customer, or purchasing assets in the money and capital markets. In either case, operating activities that are designed to deal in large volumes typically are more efficient than those activities designed for small volumes.

14 What is maturity intermediation? What are some of the ways in which the risks of maturity intermediation are managed by financial intermediaries? **LO 1.2**

If net borrowers and net lenders have different optimal time horizons, FIs can service both sectors by matching their asset and liability maturities through on- and off-balance-sheet hedging activities and flexible access to the financial markets. For example, the FI can offer the relatively short-term liabilities desired by households and also satisfy the demand for long-term loans such as home mortgages. By investing in a portfolio of long- and short-term assets that have variable- and fixed-rate components, the FI can reduce maturity risk exposure by utilising liabilities that have similar variable- and fixed-rate characteristics, or by using futures, options, swaps and other derivative products.

15 What are five areas of institution-specific FI specialness and which types of institutions are most likely to be the service providers? **LO 1.2**

First, banks and other depository institutions are key players for the transmission of monetary policy from the central bank to the rest of the economy. Second, specific FIs are often identified as the major source of finance for certain sectors of the economy. For example, regional banks, building societies and credit unions tend to concentrate on the credit needs of the residential home market. Third, life insurance and superannuation funds are commonly encouraged to provide mechanisms to transfer wealth across generations. Fourth, depository institutions efficiently provide payment services to benefit the economy. Finally, managed funds and unit trusts provide denomination intermediation by allowing small investors to purchase pieces of assets with large minimum sizes such as negotiable CDs, commercial property and commercial paper issues.

16 How do depository institutions such as banks assist in the implementation and transmission of monetary policy? **LO 1.3**

The Reserve Bank of Australia (RBA) involves banks directly in the implementation of monetary policy through changes in the reserve requirements and the official rate. The open market sale and purchase of treasury securities by the RBA in the RBA's open market operations also involves the banks the implementation of monetary policy in a less direct manner.

17 What is meant by 'credit allocation regulation'? What social benefit is this type of regulation intended to provide? **LO 1.3**

Credit allocation regulation refers to the requirement faced by FIs to lend to certain sectors of the economy, which are considered to be socially important. These may include housing and farming. For example, it is presumed that the provision of credit to make houses more affordable or farms more viable leads to a more stable and productive society.

18 Which intermediaries best fulfil the intergenerational wealth transfer function? What is this wealth transfer process? **LO 1.2**

Life insurance and superannuation funds often receive special taxation relief and other subsidies to assist in the transfer of wealth from one generation to another. In effect, the wealth transfer process allows the accumulation of wealth by one generation to be transferred directly to one or more younger generations by establishing life insurance policies and trust provisions in pension plans. Often this wealth transfer process avoids the full marginal tax treatment that a direct payment would incur.

19 What are two of the most important payment services provided by FIs? To what extent do these services efficiently provide benefits to the economy? **LO 1.2, 1.3**

The two most important payment services are payments clearing and transmission of funds services. Any breakdown in these systems would produce gridlock in the payment system, with resulting harmful effects to the economy at both the domestic and potentially the international level.

20 What is denomination intermediation? How do FIs assist in this process? **LO 1.2**

Denomination intermediation is the process whereby small investors are able to purchase pieces of assets that normally are sold only in large denominations. Individual savers often

invest small amounts in managed funds, for example. The managed funds pool these small amounts and purchase negotiable CDs, which can only be sold in minimum increments of $100 000, but which are often sold in million dollar packages. Similarly, commercial paper is often sold only in minimum amounts of $500 000 lots and, of course, multi-million dollar commercial property is often purchased by managed funds. Therefore, small investors can benefit in the returns and low risk which these assets typically offer.

21 What is negative externality? In what ways does the existence of negative externalities justify the extra regulatory attention received by FIs? **LO 1.3, 1.4**

A negative externality refers to the action by one party that has an adverse effect on some third party who is not part of the original transaction. For example, in an industrial setting, smoke from a factory that lowers surrounding property values may be viewed as a negative externality. For financial institutions, one concern is the contagion effect that can arise when the failure of one FI can cast doubt on the solvency of other institutions in that industry.

22 If financial markets operated perfectly and without cost, would there be a need for financial intermediaries? **LO 1.1, 1.2, 1.3**

To a certain extent, financial intermediation exists because of financial market imperfections. If information is available without cost to all participants, savers would not need intermediaries to act as either their brokers or their delegated monitors. However, if there are social benefits to intermediation, such as the transmission of monetary policy or credit allocation, then FIs would exist even in the absence of financial market imperfections.

23 Why are FIs among the most regulated sectors in the world? When is net regulatory burden positive? **LO 1.3, 1.4**

FIs are required to enhance the efficient operation of the economy. Successful financial intermediaries provide sources of financing that fund economic growth opportunity that ultimately raises the overall level of economic activity. Moreover, successful financial intermediaries provide transaction services to the economy that facilitate trade and wealth accumulation.

Conversely, distressed FIs create negative externalities for the entire economy. That is, the adverse impact of an FI failure is greater than just the loss to shareholders and other private claimants on the FI's assets. For example, the local market suffers if an FI fails and other FIs may also be thrown into financial distress by a contagion effect. Therefore, since some of the costs of the failure of an FI are generally borne by society at large, the government intervenes in the management of these institutions to protect society's interests. This intervention takes the form of regulation.

However, the need for regulation to minimise social costs may impose private costs on the firms that would not exist without regulation. This additional private cost is defined as a net regulatory burden. Examples include the cost of holding excess capital and/or excess reserves and the extra costs of providing information. Although they may be socially beneficial, these costs add to private operating costs. To the extent that these additional costs help to avoid negative externalities and to ensure the smooth and efficient operation of the economy, the net regulatory burden is positive.

24 What forms of protection and regulation do regulators of FIs impose to ensure their safety and soundness? **LO 1.3, 1.4**

Regulators have issued several guidelines to insure the safety and soundness of FIs:

(a) FIs are required to diversify their assets. For example, banks must get special permission from the regulators to lend more than 10 per cent of their equity to a single borrower.
(b) FIs are required to maintain minimum amounts of capital to cushion any unexpected losses. In the case of banks, the Basel standards require a minimum core and supplementary capital of 8 per cent of their risk-adjusted assets.
(c) The Australian *Banking Act* requires regulators to protect Australian dollar depositors and, as such, while this does not represent a guarantee of deposits, it requires positive action by regulators to protect depositor funds.
(d) Regulators also engage in periodic monitoring and surveillance, such as on-site examinations, and request periodic information from the FIs.

25 In the transmission of monetary policy, what is the difference between inside money and outside money? How does the Reserve Bank of Australia (RBA) try to control the amount of inside money? How can this regulatory position create a cost for the depository financial institutions? **LO 1.3, 1.4**

Outside money is that part of the money supply directly produced and controlled by the RBA, for example, coins and currency. Inside money refers to bank deposits not directly controlled by the RBA. The RBA and central banks more generally can influence this amount of money by reserve requirement and official interest rate policies. In cases where the level of required reserves exceeds the level considered optimal by the FI, the inability to use the excess reserves to generate revenue may be considered a tax or cost of providing intermediation.

26 What are some examples of credit allocation regulation? How can this attempt to produce social benefits create costs to the private institution? **LO 1.3, 1.4**

In the US, the qualified thrift lender test (QTL) requires savings and loans organisations to hold 65 per cent of their assets in residential mortgage-related assets to retain the thrift charter. Some US states have also enacted usury laws that place maximum restrictions on the interest rates that can be charged on mortgages and/or consumer loans. These types of restrictions often create additional operating costs for the FI and almost certainly reduce the amount of profit that could be realised without such regulation. There is no such regulation in Australia.

27 How do regulations regarding barriers to entry and the scope of permitted activities affect the charter value of FIs? **LO 1.3, 1.4**

The profitability of existing firms will be increased as the direct and indirect costs of establishing competition increase. Direct costs include the actual physical and financial costs of establishing a business. In the case of FIs, the financial costs include raising the necessary minimum capital to receive a charter. Indirect costs include permission from regulatory authorities to receive a charter. Again, in the case of FIs, this cost involves acceptable leadership to the regulators. As these barriers to entry are stronger, the charter value for existing firms will be higher.

28 What reasons have been given for the growth of superannuation funds and investment companies at the expense of 'traditional' banks and insurance companies? **LO 1.3**

The recent growth of superannuation funds and investment companies can be attributed to three major factors:

(a) Investors have demanded increased access to direct securities markets. Investment companies and superannuation funds allow investors to take positions in direct securities markets while still obtaining the risk diversification, monitoring and transactional efficiency benefits of financial intermediation. Some experts would argue that this growth is the result of increased sophistication on the part of investors; others would argue that the ability to use these markets has caused the increased investor awareness. The growth in these assets is inarguable.
(b) Recent episodes of financial distress in both the banking and insurance industries have led to an increase in regulation and governmental oversight, thereby increasing the net regulatory burden of 'traditional' companies. As such, the costs of intermediation have increased, which increases the cost of providing services to customers.
(c) The legislation requiring compulsory superannuation for all working people in Australia since the late 1980s has significantly increased the funds of superannuation funds and a consequent reduction in savings in traditional forms of investment such as bank deposits.

29 What significant events in the US in particular, but which spread globally, resulted from the trend for banks to shift from the traditional banking model of 'originate and hold' to a model of 'originate and distribute'? **LO 1.4, 1.5**

A major event that changed and reshaped the financial services industry was the financial crisis of the late 2000s. As FIs in the US moved to an 'originate and distribute' model, one result was a dramatic increase in systemic risk of the financial system, caused in large part by a shift in the banking model from that of 'originate and hold'. In the traditional model, banks take short-term deposits and other sources of funds and use them to fund longer term loans to businesses and consumers. Banks typically hold these loans to maturity and thus have an incentive to screen and monitor borrower activities even after a loan is made. However, the traditional banking model exposes the institution to potential liquidity, interest rate and credit risk. In attempts to avoid these risk exposures and generate improved return–risk trade-offs, banks shifted to an underwriting model in which they originated or warehoused loans and then quickly sold them. Indeed, most large banks organised as financial service holding companies to facilitate these new activities. These innovations removed risk from the balance sheet of financial institutions and shifted risk off the balance sheet and to other parts of the financial system. Since the FIs, acting as underwriters, were not exposed to the credit, liquidity and interest rate risks of traditional banking, they had little incentive to screen and monitor activities of borrowers to whom they originated loans. Thus, FIs failed to act as specialists in risk measurement and management.

30 How did the boom in the housing market in the early and mid-2000s exacerbate FIs' transition away from their role as specialists in risk measurement and management? **LO 1.4, 1.5**

The boom ('bubble') in the housing markets began building in 2001, particularly after the terrorist attacks of 9/11. The immediate response by regulators to the terrorist attacks was to create stability in the financial markets by providing liquidity to FIs. For example, the Federal Reserve lowered the short-term money market rate that banks and other financial institutions pay in the federal funds market and even made lender of last resort funds available to non-bank FIs such as investment banks. Perhaps not surprisingly, low interest rates and the increased liquidity provided by central banks resulted in a rapid expansion in consumer, mortgage and corporate debt financing. Demand for residential mortgages and credit card debt rose dramatically. As the demand for mortgage debt grew, especially among those who had previously been excluded from participating in the market because of their poor credit

ratings, FIs began lowering their credit quality cut-off points. Moreover, to boost their earnings, in the market now popularly known as the 'sub-prime market', banks and other mortgage-supplying institutions often offered relatively low 'teaser' rates on adjustable rate mortgages (ARMs) at exceptionally low initial interest rates, but with substantial step-up in rates after the initial rate period expired two or three year later and if market rates rose in the future. Under the traditional banking structure, banks might have been reluctant to so aggressively pursue low credit quality borrowers for fear that the loans would default. However, under the originate-to-distribute model of banking, asset securitisation and loan syndication allowed banks to retain little or no part of the loans and hence the default risk on loans that they originated. Thus, as long as the borrower did not default within the first months after a loan's issuance and the loans were sold or securitised without recourse back to the bank, the issuing bank could ignore longer term credit risk concerns. The result was deterioration in credit quality, at the same time as there was a dramatic increase in consumer and corporate leverage.

Web questions

31 Go to the APRA website, and list the features and bank 'specialness' described in this chapter and identify the related regulation and legislation for each of the 'specialness' features. **LO 1.3, 1.4**

The answer will depend on the date of the assignment. At the APRA website, click on 'Authorised Deposit-taking Institutions'. Then click on 'ADI Prudential Standards and Guidance Notes' and investigate the various legislation and its match to the key items of specialness identified in the chapter.

32 Go to the website of the Reserve Bank of Australia and find details of the way the RBA implements monetary policy. See www.rba.gov.au/monetary-policy/about.html, for example, and answer the following questions: **LO 1.3, 1.4**
   1 What are the tools used by the RBA to implement monetary policy?
   2 How does a decrease in the target cash rate affect credit availability and money supply?
   3 Which of the monetary tools available to the RBA is used most often? Why?

The answer will depend on the date of the assignment. At the website, click on 'Monetary Policy' and then read the material provided on the site to answer the questions asked.