



Department of Economics

ES30089 – Economics of Banking

Lecturer	Dr Andreas Krause
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Office hours	Mondays, 09.00-11.00am in 3E4.26 (no appointment required)
Lecture time	Wednesdays, 09.15-11.05am in CB2.6, weeks 1-5 and 7-11
Seminars	Weeks 3, 5, 8, 10, 11 in groups to be allocated
Webpage	http://people.bath.ac.uk/mnsak/teaching/ES30089

Economics of Banking is an elective unit for students on the BSc (Hons) Economics, BSc (Hons) Economics and Politics, and BSc (Hons) Economics and Mathematics. It is assumed that students familiarize themselves with key economics concepts as covered in ES30012 – Intermediate Microeconomics and are able to read basic balance sheets and income statements.

Unit overview

Banks have become the focus of the recent economic turmoil and their decisions on loans and investment banking activities have come under intense scrutiny. In this unit we will explore the economic incentives commercial and investment banks have in providing loans and advising clients. While this unit does not explicitly discuss the current financial crisis, the theories discussed provide tools with which to analyse aspects that contributed to the current problems.

Unit outline

Week	Topic	Readings
Economic theory of commercial banking		
1	The role of commercial banks	FR, Chs. 1-2; DKO, Ch. 2; K, Ch. 1
2	Competition in commercial banking	FR, Ch. 3; DKO, Ch. 3; K, Ch. 11
3	Debt contracts	FR, Ch. 4; K, Ch. 5
4	Relationship banking and credit rationing	FR, Chs. 4-5; DKO, Ch. 4; K, Chs. 2, 4, 6
5	Bank runs and systemic risk	FR, Ch. 7; DKO, Ch. 7; K, Ch. 14-16
6	Risk management	FR, Ch. 8; K, Ch. 3, 4
7	Consequences of banking regulation	FR, Ch. 9; K, Ch. 18
Economic analysis of investment banking		
8	Mergers & Acquisitions advisory	L, Ch. 7, AJPS, R, SZ
9	Underwriting spreads and underpricing	L, Ch. 8, BF, CR, HL
10	Financial analyst coverage	LM, MW

Problem sets

Problem sets covering a range of lectures are available and students attempt these in preparation for the seminars. These problem sets are also representative of examination questions. Students will be invited to submit in groups 2 problem sets for detailed individual feedback in preparation of the examination.

Reading List

The below books and articles are those mentioned in the unit outline above. While not all aspects of the relevant chapters and articles are covered in the lecture, it is expected that students familiarize themselves with the key results, their intuitive explanation and empirical evidence, although not the mathematical derivation of results or empirical methods.

- [AJPS] Allen, L., Jagtiani, J., Peristiani, S., Saunders, A.: The Role of Bank Advisors in Acquisitions, In: *Journal of Money, Credit and Banking*, vol. 36, 2004, pp. 197-224.
- [BF] Boehmer, E., Fishe, R. P. H.: Do Underwriters Encourage Stock Flipping? A New Explanation for the Underpricing of IPOs, 2000. Working Paper.
- [CR] Chen, H. C., Ritter, J. R.: The Seven Percent Solution. In: *Journal of Finance*, vol. 55, 2000, pp. 1105-1131.
- [DKO] Degryse, H./Kim, M./Ongena, S.: *Microeconometrics of Banking*, OUP, 2009
- *[FR] Freixas, X./ Rochet, J.C.: *Microeconomics of Banking*, 2nd edition, MIT Press, 2008
- [HL] Habib, M. A., Ljungqvist, A. P.: Underpricing and Entrepreneurial Wealth Losses in IPOs: Theory and Evidence. In: *Review of Financial Studies*, vol. 14, 2001, pp. 433-458.
- [L] Liaw, T. K.: *The Business of Investment Banking*. 3rd edition. Wiley, 2011.
- [LM] Lin, H. W., McNichols, M. F.: Underwriting Relationships, Analysts' Earnings Forecasts and Investment Recommendations. In: *Journal of Accounting and Economics*, vol. 25, 1998, pp. 101-127
- [MW] Michael, R., Womack, K. L.: Conflict of Interest and the Credibility of Underwriter Analyst Recommendations. In: *Review of Financial Studies*, vol. 12, 1999, pp. 653-686.
- [R] Rau, P. R.: Investment Bank Market Share, Contingent Fee Payment, and the Performance of Acquiring Firms. In: *Journal of Financial Economics*, vol. 56, 2000, pp. 293-324.
- [SZ] Servaes, H./Zenner, M.: The Role of Investment Banks in Acquisitions. In: *Review of Financial Studies*, vol. 9, 1996, pp. 787-815.

* A newer third edition of Freixas/Rochet has been published, but as the second edition is widely available in the library and in my view better, I will use this for reference, but the newer edition can be used by students.

Alternatives to [FR] for a range of topics are these books, although students are advised that the coverage might not be comprehensive, more detailed in other aspects and differs in parts. MT provides a more intuitive approach, while K is similarly formal as FR but often takes a different approach:

- [MT] Matthews, K./ Thompson, J.: *The Economics of Banking*, 3rd edition, Wiley, 2014
- [K] Keiding, H: *Economics of Banking*, Palgrave, 2016

For those interested in the activities and practices of investment and commercial banks, the following books might be helpful:

- Fleuriet, M.: *Investment banking explained*, McGrawHill, 2008
- Ianotta, G.: *Investment Banking*. Springer, 2010
- Rosenbaum, J., Pearl, J.: *Investment Banking*. Wiley, 2009
- Gup, B. E./Kolari, J. W.: *Commercial banking*, 3rd edition, Wiley, 2005
- Heffernan, S.: *Modern Banking*, Wiley, 2005

Assessment

Assessment is by final examination only. The examination of this unit will consist of an open-book examination (all materials apart from lecture slides are allowed) lasting two hours.

Marking criteria in the examination

When marking the exam I will be paying particular attention to the following aspects, in no particular order of importance:

- Choice of an appropriate model/framework that can be used to address the problem in the question, with additional well justified assumptions being made as appropriate and needed
- Presence of a coherent argument being made (within the framework of the model chosen) that leads from observations to meaningful results on any particular point being made
- A well-argued overall conclusion that brings together the different arguments made throughout your answer into a single final result or two opposing results conditional upon certain aspects discussed before as appropriate
- Avoidance of the discussion of irrelevant aspects that do not directly contribute to your answer
- Consideration of alternative explanations and approaches to the one chosen and justification of the chosen approach

The marking of answers like those are subjective, thus no firm rules or right/wrong answers can exist. Roughly answers might be characterized as follows:

- **Fail:** You choose the wrong theory or model and typically you do not apply it to the problem at hand but rather describe the theory itself. It may also be a case of choosing the correct theory or model but not showing how it and its results relate to the problem in the question or misinterpreting its relevance.
- **Third:** You choose a theory or model that is wrong but make an effort to show its relevance. Alternatively you might choose the correct model but fail to argue its relevance convincingly or make substantive mistakes in its application.
- **Lower Second:** You choose the correct theory or model, but your arguments to its relevance are incomplete or partially wrong. You may have all elements in place, but not connected to form a coherent argument for your analysis.
- **Upper Second:** You use theories and models well to support your arguments, but you may not properly consider alternative theories and other explanations that do not directly emerge from conventional theories. Your explanations using models and theories show some gaps or inconsistencies.
- **First:** You support your arguments well with existing theories or models, consider alternatives to the models you chose as well as look beyond the models themselves by considering alternative explanations.