Topics in Banking: Theory and Practice

Lecture Notes 3

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Transaction costs

Transaction costs refer to the expenses of carrying out trades or making financial decisions. When discussing about the trade of goods and services, transaction costs are of two types:

a) Coordinating costs: they mainly refer to the costs needed to make the existence and location of potential buyers and sellers known to each other, and of bringing buyers and sellers together to transact. This type of transaction costs is also related to the determination of prices as well as other details of transactions between buyers and sellers.

b) Motivation costs: these are the costs of motivating buyers and sellers to adhere to the terms and conditions of their transactions. They emerge from the lack of relevant information necessary to determine whether the terms of an agreement are mutually acceptable, or, actually, being met by the participated parties. They also stem from the inability of either of the parties to commit itself to carry through on promises as described in the agreed contract.

Bank-based and market-based financial systems[1]

i) Bank-based view

The bank-based view highlights the positive role of banks in:

a) Acquiring information about firms and managers and thereby improving capital allocation and corporate governance (Diamond, 1984).

b) Managing cross-sectional, intertemporal, and liquidity risk and thereby enhancing investment efficiency and economic growth.

[1] The analysis here is based on the article of Levine (2002).

c) Better monitoring firms and reducing post-lending moral hazard via asset substitution.
d) Mobilizing capital to exploit economies of scale and scope.
e) Effectively forcing firms to repay their debts, especially in countries with weak contract enforcement capabilities. In fact, without powerful banks to force repayment, external investors may be reluctant to finance industrial expansion in countries with underdeveloped institutions.

The bank-based view also stresses the shortcomings of market-based systems:

a) Well-developed markets quickly and publicly reveal information, which reduces the incentives for individual investors to acquire information. Banks, however, mitigate this problem since they form long-run relationships with firms and do not reveal information immediately in public markets.
b) Liquid financial markets create a myopic investor climate. In liquid markets, investors can inexpensively sell their shares, so that they have fewer incentives to exert rigorous corporate control.

ii) Market-based view

The market-based view highlights the growth enhancing role of well-functioning markets in:

a) Fostering greater incentives to research firms since it is easier to profit from this information by trading in big, liquid markets.
b) Enhancing corporate governance by facilitating takeovers and making it easier to tie managerial compensation to firm performance.
c) Facilitating risk management.

The market-based view further stresses problems with banks.

a) Banks can slow down innovation by extracting informational rents and protecting established firms with close bank-firm ties from competition.
b) Banks with few regulatory restrictions on their activities may collude with firm managers against other creditors and impede efficient corporate governance. In contrast, competitive capital markets play a positive role in aggregating diffuse information signals and effectively transmitting this information to investors, with beneficial implications for firm financing and economic performance.

iii) Financial services view (Levine, 1997)

According to this view, the main issue is neither the strengthening of banks nor markets alone. Rather, the issue is to create an environment in which financial intermediaries and markets provide sound financial services. Conceptually, the financial services view minimizes the significance of the bank-based versus market-based debate.

iv) Law and finance view (La Porta et al., 1998 & 2000)

A well-functioning legal system facilitates the operation of both markets and banks. It is the overall level and quality of financial services -as determined by the legal system- that improves the efficient allocation of resources and economic growth. In particular, La Porta et al. (2000) argue that laws and enforcement mechanisms constitute a more useful way to distinguish financial systems than focusing on whether countries are bank-based or market-based.

Securitization[2]

The essence of structured finance is the ***pooling*** of assets like, e.g., loans, bonds, or mortgages, and the subsequent issuance (***tranching***) of a prioritized capital structure of claims, known as tranches, against these collateral pools. This is to say, structured finance is a two-step procedure involving pooling and tranching. In the first step, a large collection of credit-sensitive assets is pooled in a portfolio, which is typically referred to as a Special Purpose Vehicle (SPV). SPV is then separate in step two from the originator's balance sheet to isolate the credit risk of its liabilities -the tranches- from the balance sheet of the originator.

The tranches are prioritized in how they absorb losses from the underlying portfolio. For instance, senior tranches only absorb losses after the junior claims have been exhausted, which allows senior tranches to obtain credit ratings in excess of the average rating on the average for the collateral pool as a whole. Hence, as a result of the prioritization scheme used in structuring claims, many of the manufactured tranches are supposed to be safer than the average asset in the underlying pool.

[2] See Coval et al. (2009)

References

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