Syllabus for Strategic Management of Financial Institutions
15.518 (9 credits), Fall 2017 (M and W from 10:05 to 11:25am) Room E51-376

Contact Information:
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Course Materials
Electronic course reader
Laptops permitted in class

This course will be graded by letter. Listeners will not be allowed.
Graduate P/D/F Option will not be allowed.
There will be a final exam during the final exam week in December.
But Sloan Fellows may choose, instead of a final exam, to write a paper at the end of the course.

The grade will be based 50% on the final exam (or paper for Sloan Fellows), 35% on class participation and 15% on one written submission based on an assigned case. In most cases, however, you will NOT be required to hand in answers to the assignment questions; these are study guides for your own personal use.

COURSE SUMMARY

Strategic management of financial institutions reviews a broad range of institutions that accept money from savers and invest that money in stocks, bonds or other assets. The course will explain how each of these institutions functions in terms of economics and how each is regulated by government agencies. The course will cover pass-through institutions where the savers receive the return on their investments minus management expenses – mutual funds, hedge funds, and sovereign funds. It also covers institutions offering savers some form of guaranteed returns – banks, insurance companies, and Fannie Mae. Finally, the course will cover pension plans; both defined contribution and defined benefit plans.

The course is geared to the non-financial expert with background notes as well as case studies on actual institutions. The course is taught from the viewpoint of someone advising or dealing with these institutions, as well as a public official deciding upon regulatory policy.

RECOMMENDED READING

For students who do not feel comfortable with the myriad of financial terms, I recommend as good sources either of the books listed below. (For the Lanchester book, refer only to the second part with a glossary of financial terms).


A few copies of these books will be on reserve at the Dewey Library.
Class 1. September 6, 2017

Why Investors use financial intermediaries


Pozen, Robert and Hamacher, Theresa, “Has the death knell of active management been rung too soon?”, Financial Times (February 1, 2015).

Foley, Stephen and Wigglesworth, Robin, “Active managers exposed as most US equity funds lag behind market”, Financial Times (September 15, 2016).

Assignment:

1. What are the pros and cons of savers investing through financial intermediaries, instead of investing directly in securities?

2. What is the difference between a pass--through or agency intermediary and a guarantor or principal intermediary?

3. Why are financial intermediaries regulated much more heavily than industrial corporations?

4. Why do we have governmental insurance for certain types of intermediaries but not for others?

Part I: Pass--Through Funds

Class 2. September 11, 2017

Introduction to US mutual funds

Reading: Note: Introduction to Mutual Funds (310117)
Case: Controlling Hot Money (311022)

Assignment:

1. From the investor perspective, what are the key attractions of mutual funds relative to other methods of buying foreign securities? What do these attractions imply for managing such mutual funds?

2. What is the impact of the short---term trading on Japanese Equities Fund during August 1997? Identify and quantify, to the extent feasible, the various categories of costs that result from short---term trading on the fund. Which group of fund shareholders bear which type of costs from short---term trading?

3. What are the disadvantages (opportunity costs and administrative costs) of controlling “hot money” in the Japanese Equities Fund? Who bears these costs?

4. Assuming that action is warranted, what strategy will you propose to the Japanese Equities Fund directors that is likely to reduce substantially the short---term
May 16, 2017

purchases and redemptions (or their impact) by shareholders while minimizing the disadvantages identified above? (Be specific and quantify your recommendation).
Alternatives may include:
   a. Restricting the number of transactions per account
   b. Restricting the manner in which redemption orders are taken
   c. Adding a redemption fee to the fund
   d. Adding a back---end load to the fund

5. What security prices are normally used by the Japanese Equities Fund at 4p.m. ET when NAV is determined? What other prices could be used? What other valuation time could be used?

6. Refer to Exhibit 9 for the price movements in Nikkei futures traded in Chicago during the US business hours on January 16, 1997. For that day, should you adjust the price of the Japanese Equities Fund for some or all of the securities it owns? Would you make a different valuation decision if futures were up by the same amount or percent that they were down?

**Class 3. September 13, 2017**

**Hedge funds in the US**

**Readings:** Note: Disclosure, Regulation, and Taxation of Hedge Funds versus Mutual Funds in the U.S. (Rev. May 18, 2012; 310131)

Case: The Dynamis Fund: An Energy Hedge Fund (UV0621) – do NOT read exhibits

Please take note of the edits to Dynamis Case detailed below:

Edit A: The first two sentences of the case on page one should read:
As Fred Bocock looked at the performance of the Energy Hedge Fund[1] (also known as the Dynamis Fund) and the Energy Portfolio (“Portfolio”) at the end of the first quarter of 1998, he was relieved to see that the Portfolio was up 2.3% for the first quarter. But he could not help focusing on the facts that the Portfolio was still down 15% from the end of the third quarter 1997.

Edit B: On page 7, qualified investors must each have $5 million in investments (excluding homes).

**Assignment:**

1. How does the Energy Hedge Fund avoid registration under the Investment Company Act of 1940? What advantages does the Energy Hedge Fund enjoy relative to the Energy Portfolio?

2. What is the difference between the management fee of the Energy Portfolio and the Energy Hedge Fund? Will SEC—registered managers of hedge funds be allowed to charge performance fees?

3. What are the tax differences between the Energy Portfolio and the Energy Hedge Fund? From the perspective of investors and the manager?

4. What are the most significant effects of the JOBS Act as applied to hedge funds and mutual funds in the US?
5. In terms of changing the governance or strategy of a publicly traded company, would a hedge fund be in a better or worse position than a diversified mutual fund?

Class 4. September 18, 2017
UCITs in Europe

Reading: Case: Barclays Wealth: Reignite WAR or Launch AlphaStream? (310090)
Note: Regulation of Hedge Fund Managers in the U.K. Before and After the Global Financial Crisis (Rev. June 19, 2012; 311014)

Assignment:
1. What are the advantages and disadvantages of selling a UCITs fund versus a fund registered just in the UK? Can you sell a UCITs fund in the US or in Hong Kong?
2. UCITs permit a broader universe of investment options than are available to US regulated mutual funds. Are the protections afforded to investors under the UCITs regime adequate? Assess the effect of the financial crisis on the receptivity of investors to hedge fund offerings under UCITs.
3. What should Thomas Fekete recommend? Why?
4. What are the pros and cons of liquid alternatives -- mutual funds with hedge-type features -- relative to traditional hedge funds in the US and EU?
5. If the U.K. no longer is part of the EU, how will asset managers of mutual funds and hedge funds based in the U.K. offer such funds to investors in the EU?

Class 5. September 20, 2017
Money Market Funds

Reading: Case: Breaking the Buck (310135)
“Money market funds in China become less systemically risky,” Brookings (May 16, 2016)

Assignment:
1. What are the similarities and differences between an account in a money market fund and a deposit in an FDIC---insured bank?
2. Before March 7, 2009, should McCall decide to have RPGXX apply for an extension of the Treasury insurance for a second time?
3. Which, if any, of the proposed changes to RPGXX’s updated prospectus would you support as an independent director of the fund?
4. At the end of 2010, the SEC adopted stricter rules on money market funds — reducing their average maturity from 90 to 60 days, decreasing their maximum illiquid assets from 10% to 5%, and requiring 10% of their assets to have daily liquidity. How would you evaluate these new rules?
5. The SEC press release (in the readings for this Class 6) proposed alternative restrictions on certain types of money market funds, which were perceived to pose a significant risk to the US financial system. Would you support any of these
6. How would you assess the regulation of Chinese money market funds?

Part II: Hybrid Institutions

Class 6. September 25, 2017

Exchange Traded Funds (ETFs)

Reading: Case: Exchange---Traded Funds at Vanguard (A) (311134)
Case: Exchange---Traded Funds at Vanguard (B) (311135)
“Actively managed exchange traded funds are the NextShares big thing,” Financial Times (April 12, 2015)

Assignment (for A case):
1. What are the differences between mutual funds and closed-end funds? Between these two types of funds and ETFs?
2. How does the market for ETFs compare to the market for mutual funds? Why are there such differences in the degree of market concentration?
3. In 2001, what were the major challenges for Vanguard in entering the ETF market? How could these challenges be overcome?

Assignment (for B case)
1. In 2009, should Vanguard launch actively managed ETFs? Or ETFs based on other indices?
2. How could Vanguard attract a broader investor base for its ETFs? Could Vanguard make better use of its brokerage operations to promote its ETFs?
3. Were ETFs a useful financial innovation? What were the drawbacks of ETFs to investors?
4. What are the pros and cons of actively managed ETFs? Are they more like mutual funds or ETFs?

Class 7. September 27, 2017

Government Programs for Home Mortgages

Crowley and Weiss, “Fannie Mae, Freddie Mac, and Housing Finance Reform,” National Low Income Housing Coalition

Assignment:

Strategic Management of Financial Institutions
1. What is the rationale for FHA insurance of home mortgages issued by banks? What is the role of Ginnie Mae?

2. What is the justification for Fannie Mae and Freddie Mac? Why did they become insolvent in 2008?

3. Should we privatize the market for home mortgages in the US? What exactly would that mean?

4. Would you support any of the proposals for a new Federal agency or regulated utility to guarantee private mortgages with a large deductible from the private sector?

Class 8. October 2, 2017
Private Market for Mortgage Securitization
Note: Credit Rating Agency Reform in the US and EU (April 27, 2012; 312127).

Assignment:
1. What are the positive functions and negative aspects of a private system for mortgage securitization?

2. Will the problems of mortgage securitization be solved by the risk retention rules? Do you agree with the changes in the re-proposed rules on qualified residential mortgages (QRM)?

3. What is your evaluation of the proposed and actual US reforms for credit rating agencies?

4. What is your evaluation of the proposed and actual European reforms for credit rating agencies?

5. Should we entirely eliminate any legal requirements for credit ratings, or assign agencies to deals by lottery?

Class 9. October 4, 2017
Real estate investment trusts in the US
Reading: Case: Cypress Sharpridge: Raising Capital in a Time of Crisis (310140)

Assignment:
1. What is a REIT and why do REITs exist, as a matter of public policy?

2. Would you invest in a REIT? Why or why not, and do you distinguish between equity and mortgage REITs? Who should invest in a REIT?

3. After the financial crisis, what are the long-term prospects for the REIT industry? Should
retail businesses split into a REIT and a retail company?

4. Evaluate Kevin Grant’s leadership. Have Cypress Sharpridge’s difficulties been self-inflicted or out of Kevin Grant’s control? What should he have done differently in navigating the financial crisis?

5. What should Kevin Grant do now?

Class 10. October 11, 2017
Visit to trading floor at MFS Investment Management

Address: 111 Huntington Avenue, Boston 02116

Class 11. October 16, 2017
Sovereign Funds: Europe

Reading: Case: Norway Sells Wal-Mart (308019)

Assignment:

1. What are the potential ramifications of the Norwegian Fund’s sale of Wal-Mart stock? Please consider the perspectives of all Wal-Mart stakeholders.

2. Was the sale of Wal-Mart stock consistent with the ethical and economic mandates of the Norwegian Fund? What other courses of action could have been pursued by the Ethics Council or the Minister of Finance?

3. How should Ray Bracy respond to the Norwegian Fund’s sale of Wal-Mart stock?

4. What are the economic and social issues raised by the growth of sovereign wealth funds? What does the sharp drop in oil price mean for these funds?

5. Should the Norwegian Fund become an activist shareholder? Should the Fund sell all of its fossil fuel stocks?

Class 12. October 18, 2017
Sovereign Funds: Asia

Reading: Case: Two Key Decisions for China’s Sovereign Fund (311-137)

Assignment:

1. What were the Chinese government’s goals in setting up CIC? Were these goals compatible with each other?

2. Should the Fed exempt CIC and Huijin from the Bank Holding Company Act to allow ICBC’s 2011 acquisition of banking branches in the US?

3. As a member of CIC’s investment team, how would you view CIC’s investment in MS
at the beginning of 2011?

4. For countries receiving investments from SWFs, what were some economic and regulatory issues raised by the growth of SWFs?

5. How should SWFs conduct themselves when making investments in foreign countries? Do you support the Santiago principles?

Part III: Guarantors: Banks

Class 13. October 30, 2016
Introduction to Commercial Banks
Reading: Case: Crawford Development Co. and Southeast Bank of Texas (UV1094)
Note: Bank Capital Structure: A Primer (UVA-F-1555)
Assignment:

1. What are the differences between Basel I and Basel II? Which one is better designed to serve the purposes of a capital requirement?

2. Looking at the TinosBank on page 5 of the reading, Bank Capital Structure: a Primer, how much capital would be required to meet the leverage ratio?

3. If you were the loan officer, would you approve the loan application of Crawford? What conditions would you put on the loan?

4. What is the impact of capital requirements on the bank’s profitability? What happens to the balance sheet and income statement of the bank if it suffers a loss on a loan?

5. How does a bank differ from a mutual fund in terms of profitability? What is the legal status of the savers in a bank and in a mutual fund?

Class 14. November 1, 2017
Commercial Banks in Crisis
Reading: Case: The Southeast Bank of Texas in the Financial Crisis (310141)
Assignment:

1. Evaluate the capital needs of the Southeast Bank of Texas in March 2009 under Basel II?
   a. In Alan Russell’s scenario
   b. In Manuel Mayerson’s scenario

2. What should Irwin Greff and the Southeast Bank of Texas do?
   a. Should they accept FDIC guaranteed debt?
   b. Should they accept a capital infusion from the US Treasury?

3. Consider in each scenario:
   a. Should the bank advertise the new FDIC guarantees on noninterest and interest bearing accounts in an attempt to attract deposits?
b. If so, how should the bank put the newly acquired money to work?

4. Evaluate the new Federal Government policies on FDIC guarantees and CPP that were introduced in the wake of the financial crisis, as applied to this type of bank.

5. How will Basel III impact the business strategies of banks? Does Basel III address the shortcomings of Basel I and II?

For purposes of simplifying the calculations for this case, please note that the loan loss reserve should be kept constant in all three scenarios, and also that the loan loss revenue should be considered TIER 2 capital for purposes of Basel II.

In addition, please note that the leverage ratio is based on total assets, not risk-adjusted assets, and capital for this purpose includes both TIER 1 and TIER 2 capital. Furthermore, to be adequately capitalized, a bank needs a leverage ratio of at least 4% under Basel II; and to be well-capitalized, a bank needs a leverage ratio of 5% under Basel II.

Class 15. November 6, 2017
Investment Banks in Crisis

Reading: Case: Goldman Sachs: A Bank for All Seasons (A) (310055)
Summary of the Volcker Rule under Dodd---Frank
“Safeguarding European banks, Volcker plus,” The Economist (February 1, 2014).

Assignment:

1. Would a return to Glass---Steagall type regulation help avoid another financial melt-down?

2. What were the costs and benefits to Goldman Sachs of becoming a bank holding company in 2008?

3. What exactly is prohibited by the Volcker rule and what conduct falls within the exemptions?

4. Would you favor Vicker’s rule for UK banks or Barnier’s proposal for EU banks over the Volcker rule?

5. What will happen to the activities prohibited for banks under the Volcker rule or similar rules, or activities that become uneconomic for banks because of much higher capital requirements?

Class 16. November 8, 2017
Large Bank Bailouts

Reading: Case: Bank of America Acquires Merrill Lynch (A) (310092)

Assignment:

2. What was the rationale of the Treasury in pressuring all eight large banks to accept federal capital?
3. Should Lewis have accepted the preferred stock from the US Treasury in October 2008 under the Capital Purchase Program (CPP)?

4. Was the Merrill deal attractive to BofA at the $50 billion price in September? Would you have negotiated a different deal for BofA in acquiring Merrill?

5. What should have Lewis disclosed at the time of the shareholder vote on the merger? On bonuses at Merrill and Merrill’s losses?

6. Were the terms of the second tranche of stock and the asset guarantee good from BofA’s viewpoint? From the US taxpayer’s viewpoint?

7. Should Lewis have walked away from the deal or asked for more federal assistance in order to do the deal? How important should systemic risk be to Lewis and BofA?

**Class 17. November 13, 2017**

**Limiting Systemic Risk**

**Reading:**

- Selected sections of Dodd Frank Act on Resolution Authority

**Assignment:**

1. What types of financial firms other than large banks should be deemed systemically risky institutions (SRIs)?

2. If US officials applied the resolution authority to a large bank in financial trouble, what would happen to its shareholders, creditors, directors and executives?

3. Do large banks have a competitive advantage in funding? Are they still perceived as “too big to fail” despite recent reforms?

4. What is your evaluation of the recent EU reforms to reduce systemic risk? How does the EU approach to bailing out failing banks compare to the US approach?

5. Do you believe that the new EU restrictions on bonuses of senior executives at large banks will help reduce their riskiness? Should those restrictions be applied to asset managers and other financial firms?
6. Do you support a financial transactions tax? Why or why not?

**Class 18. November 15, 2017**

**Lending through Non-Banks**

**Reading:**  
Case Shacom.com Inc., L. Ivey 908N15  
“Pitfalls for the Unwary Borrower Out on the Frontiers of Banking,” *New York Times*  
(September 14, 2015).

**Assignment:**

1. What are the differences between the traditional huei system and the proposed Shacom huei product?

2. Describe the key risks associated with the lending system form the point of view of the company, Shacom, as well as the individual. What are the benefits to the company and individuals lending and borrowing through the huei product versus the traditional banking system?

3. If you were Head of the Financial Supervisory Commission (FSC) in Taiwan, how would you look to regulate this new platform of borrowing and lending between individuals? What are some of the restriction you might impose?

4. If you were Mr. Yung-Sung Chien, in which geographic areas would you look to expand the huei product? Why?

5. What are the pros and cons of online lending in the US? Do online lenders pose significant new risks to the financial system?

**Part IV: Life Insurers and Retirement Plans**

**Class 19. November 20, 2017**

**Introduction to life insurers**

**Reading:**  
Note: The U.S. Life Insurance Industry (310091)  
Case: Malcolm Life Enhances Its Variable Annuities (311041)

**Assignment:**

1. What are the key differences in risk sharing for life insurance versus annuity products? Does it make sense for a company to offer both types of products?

2. What are the key risks in an annuity contract’s accumulation phase and its payout phase? Why don’t people like to convert deferred contracts into income streams?

3. What products is a potential customer most likely to consider as alternatives to a deferred variable annuity? How does a guaranteed minimum withdrawal benefit help insurers compete against these products?
4. In what ways does a guaranteed minimum withdrawal benefit make sense from a company perspective? What are the key risks to an insurance company offering a guaranteed minimum withdrawal benefit with a one-year ratchet feature?

5. Do you agree that Malcolm should offer a GMWB? The CMO proposes offering the GMWB with a current charge of 50 basis points per year and a maximum charge of 100 basis points per year. The CFO proposes a current charge of 100 basis points and a maximum of 150 basis points. Would either or both of the proposed prices for the current charge provide Malcolm with a reasonable return on its capital?

6. Should the GMWB have a lifetime guarantee? If so, at what price? Assuming the lifetime guarantee was priced at 18bp and reinsurance costs were 17bp, should Malcolm Life reinsure the longevity risk associated with the feature?

Class 20. November 27, 2017
Financial conglomerates
Reading: Case: Ping An (311133)
Assignment:
1. What are the benefits and costs of a financial conglomerate model?
2. Why might a financial conglomerate model work in some countries better than others?
3. What are some of the issues Ping An faced when making large investments/acquisitions (e.g., Fortis and Shenzhen Development Bank)?

Class 21. November 29, 2017
Reinsurance among insurers
Reading: Note on the Reinsurance Industry (311102)
Assignment:
1. What are the reasons why an insurer might decide to utilize reinsurance?
2. What are the various mechanisms by which reinsurers manage their risks and returns relative to insurers?
3. What is the structure of the reinsurance industry? What does that structure imply for insurers?
4. During the negotiations (see below), what decisions did you make and why?
5. From the negotiations, what did you learn about the ability of insurers and reinsurers to mutually benefit from their deals?

Instructions for negotiations:
You will be assigned one of three negotiating positions: insurer, reinsurer A or reinsurer B. You will receive a confidential memorandum for your position, along with instructions on how to conduct the negotiations before class. You should also be given
access to a spreadsheet with financial data relevant to your position.

**Class 22. December 4, 2017**

**State DB plans**

Reading:  
Case: Tough Choices for the Illinois Pension System (311---139)  
Note on U.S. Pension Accounting (311---115)

Assignment:  
1. What factors contributed to the underfunding of the Illinois’ pension system?  
2. The Illinois pension system has been underfunded for at least sixty years, but the state has remained solvent. Is this time different?  
3. How big a hole does Illinois face according to the state? Is this estimate realistic?  
4. In each of the alternatives highlighted at the end of the case, what will happen to the PBO of the Illinois pension system?  
5. Which of the alternatives highlighted at the end of the case should Dhanraj recommend? Why?

**Class 23. December 6, 2017**

**DC plans in the US**

Reading:  
Case: Redesigning a 401(k) Plan at Haley Midland (311---128)  

Assignment:  
1. How are 401(k) plans different from DB plans? How are contributions made to 401(k) plans, and how are funds withdrawn from the plan? What tax benefits do employees and employers receive for participating in a 401(k) plan?  
2. Why do you think Haley---Midland had low participation rates among its lower--tier employees? What options do they have to increase employee participation? Should they adopt automatic enrollment? If so, should they use a QACA or EACA?  
3. If Haley---Midland adopts automatic enrollment, what should it choose as its Qualified Default Investment Alternative? Why? How many other investment alternatives should they offer? Should they offer Haley---Midland stock?  
4. How will the new Labor Department rules change the relationship between retirement investors and their brokers or financial advisors?

**Class 24. December 11, 2017**

**DC Plan Design Around The World**

Readings:  
“China’s pension problems will not be solved by more children,” *Financial Times*

Assignment:

1. Is the retirement system in Singapore a DC or DB plan?
2. What are the pros and cons of the Chilean pension system?
3. What aspects of the Singapore or Chilean system might be adopted to improve the Chinese pension system?
4. Should the US adopt something similar to the Canadian pools to increase participation in DC plans?
5. Do the pension systems of Netherlands and New Brunswick deal well with the typical drawbacks of both DB and DC plans?

Class 25. December 13, 2017 (No readings assigned)
Review course
Course evaluations

Final exam — to be given during the final exam week for the fall semester during December.
Paper alternative for Sloan Fellows—due on December 15.