

## FINANCIAL SYSTEM DESIGN

### MANAGER-SHAREHOLDER CONFLICT

- Managers are willing to take risk, but shareholders of public companies are generally risk-averse
- ESOPs as part of manager compensation
- Closely-held company shareholders desire minimised taxes, as compared to wealth maximisation
- Managers given excess salaries as tax-deductible expense
- CEOs want to build personal legacies
- Modify capital structure to preserve control of management team
- Pet projects, frauds, nepotism, cash dividends, new capital raising to dilute voting rights

### STAKEHOLDER-LENDER CONFLICT

- Claim on assets
- Creditors eat into shareholder's dividends
- Creditors want ICR and DSCR good, while shareholders want MPS maximised.
- Creditors oppose high risk projects
- Repurchase of equity by borrowing additional funds

### CONFLICT RESOLUTION AND FINANCIAL SYSTEM DESIGN

#### BANKING ORIENTED

Bank's hold controlling interest in firms to whom they lend

Solution -

Bank can monitor performance of the firm's management

Bank has regulation over management – can fire an incompetent manager

## CONFLICT RESOLUTION AND FINANCIAL SYSTEM DESIGN

### MARKETS ORIENTED

Diffused ownership – little reason for stockholders to monitor manager performance

CEO decides BODs, who ignore CEO's meagre performance

Solution –

Corporate Takeover

Management's compensation linked to performance anticipated by shareholders

BANK ORIENTED	MARKET ORIENTED
Economy depends on how well or poorly banking industry is doing	Economy depends on how well or poorly stock market is doing
Banks focus attention on loans	Banks earn thru fee-based services
Wealth spread evenly - most are on either end of the income slab	Wealth spread unevenly – any individual can gain or lose
	Rich countries mostly use this economic system
Expected to help regulate the economy and not make much profits- Little or no govt assistance, private sector not in position to compete with banks	Banks operate to make profit –investments by private and govt sectors – banks have to adjust practices and interest rates to compete
Laws are made and carried out by government – civil law	Separate judicial system – common law – not set up and

## DIMENSIONS OF A WELL-FUNCTIONING FINANCIAL SYSTEM

### 1. ORIGINATION

- Providing households and firms with financial products and services to manage liquidity and location risk.
- High quality origination enables this in a smooth, convenient and affordable manner.

## DIMENSIONS OF A WELL-FUNCTIONING FINANCIAL SYSTEM

### 2. RISK TRANSMISSION

- Orderly reassignment of risks from originators to well-capitalised risk aggregators
- Financial firms construct financial products to transfer risks to households in return for risk premium
- Global scale derivatives transactions
- Risks which cannot be transferred get transferred to shareholding households

## DIMENSIONS OF A WELL-FUNCTIONING FINANCIAL SYSTEM

### 3. RISK AGGREGATION

- Local originators to transfer systematic risk like natural disaster or political event to capital markets or well-capitalised, diversified risk aggregators
- Risk aggregation done by commercial banks, insurance companies, mutual funds
- Govt can play key role in risk aggregation in areas not suitable for commercial institutions eg. SME guarantee

## ECONOMY OF JAPAN

- Big Four securities houses in Japan are Nomura, Daiwa, Nikko and Yamaichi
- Stock Exchanges in Japan - Tokyo Stock Exchange and Osaka Stock Exchange
- Currency of Japan is Yen
- Regulator of Japanese banks is Bank of Japan (Nichigin)

## ECONOMY OF JAPAN

- Known as Land of the Rising Sun
- Types of banks - Commercial banks, Long term credit banks, Trust banks, Mutual loan and savings banks
- Five largest city banks in Japan - Daiichi Sangyo Bank, Sumitomo Bank, Fuji bank, Mitsubishi Bank, Sanwa bank
- Japan Bank for International Cooperation (JBIC) is the only government institution which finances foreign trade and investment.

## ECONOMY OF USA

- Regulator of Banking system is Federal Reserve
- Regulator of Stock markets is Securities and Exchange Commission
- Stock exchanges in the country are New York Stock Exchange (NYSE), American Stock Exchange (AMEX) and NASDAQ
- Currency of USA is Dollar

## ECONOMY OF UK

- Regulator of Banking system is Bank of England
- Regulator of Stock markets is The Financial Conduct Authority
- Stock exchanges in the country are London Stock Exchange
- Currency of USA is Pound Sterling