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Financial Intermediary Institutions

Banks and institutional investors

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In the past three years, a number of books and articles have been published focusing on the ongoing financial crisis which broke out in 2007. Most of them analyse the causes and ripple effects of the crisis, with a frequent use of sensational tools. Some claim that the events were the consequence of the excessive risk-taking by the financial intermediaries (obviously in the hope of higher yields), while others highlight the responsibility of the regulatory and supervisory agencies. The spread of securitisation and structured financial instruments was accompanied by significantly larger risks and the appearance of new risks, often unknown even to the issuers. In the meantime, the supervisory and regulatory agencies like ostriches stuck their heads into the sand and, apart from a few fire-fighting measures, almost idly watched the events. It is no wonder, therefore, that the trust of society in the financial markets was shaken by the crisis. Today's economies are money-based economies, in which the existence of heavily trust-based financial intermediation and the implementing institutions thereof, and the institutional system itself are of major importance for the operation of the economy. In relation to the crisis, the role of institutional stability and transparent operation, coupled with more effective and internationally co-ordinated supervisory work have appreciated. The competent organisations have already taken the first steps towards restoring the stability of the financial system. However, the trust of society is a more sensitive issue than a particular legal regulation or recommendation. Perhaps we should start by speaking the same language, make the structure of the financial intermediation system clear, and clarify the role and specificities of the particular institutions.

The book by *Mihály Erdős* and *Katalin Mérő* is a bull's eye both in terms of content and timing. In their book they not only dissect the causes of the crisis but, relying on the latest international literature, also endeavour to present the financial intermediation actors, relevant from a Hungarian standpoint. The book also fills a gap in the sense that it presents and captures all closely related institutions playing a role in intermediation in their complexity instead of providing an isolated picture of all of them. Apart from the clarification of basic concepts and definitions, the book, relying on the results of research and analyses, also describes the specificities, key issues, pronounced problems, regulatory features and latest developments of each area. The book is equally useful for readers interested in finance and students studying at various levels of higher education, as through its diversity it inspires further reflection and debate. Although due to the crisis the regulatory issues are put in the forefront of attention, the book is excessively dominated by issues related to banks and banking regulations. In addition, it would have been nice to read more about the activities of the credit rating agencies and the regulatory problems related to them.

■ In *Chapter 1* the authors analyse the relationship between economic growth and the degree of development of the intermediary systems from several aspects. *Schumpeter's* views, according to which the role of the bank is to select market participants worthy of credit within their scope of competence granted by society and the delegated observer role defined by Diamond, economic history experience, i.e. the mathematical and statistical analysis of data series of many decades, all confirm that advanced financial intermediation has a favourable impact on economic growth. The research results of *Levine* and *his co-authors* go even further and prove that banks and capital markets affect economic growth primarily through the increase of productivity. The following conclusions cited from Levine put an interesting light on the events of the world economy: *1.* in countries where the financial intermediation system is more advanced, faster economic growth may be expected, *2.* it is important that economic policy decision-makers attach high priority to the reform of the financial system.

■ *Chapter 2* deals with bank models and the specificities of banking operations, the main banking risks and various options available for their management, while the description of the bank crisis adds colour to this chapter. We can also learn about the paradigm shift in the banking sector, i.e. the reasons for the emergence of the so-called *originate to distribute* banking model, and the specific features of the bank of today. In this model, a bank provides a loan for the purpose of passing on its risks to other market actors either in part or in full, through securitisation. Irrespective of the banking model, it is a fundamental expectation towards banks to be liquid and solvent, as well as profitable at all times. However, there is a contradiction among the three basic principles, which may lead to a conflict in the operation of banks. The authors list the main risk types, and describe and summarise the various techniques and methods available for measuring and managing those risks. The chapter finishes with the description of a few bankruptcies and bank crises which created big scandals in the recent past.

■ Institutional investors collectively manage a large amount of assets, collected for specific, pre-defined purposes. Institutional investors include investment funds, life insurers, pension funds and other non-classic investment funds, such as hedge funds or venture capital companies. In *Chapter 3,* the authors present the specificities of institutional investors and the financial products and services offered by them, illustrating the origins of establishment of such financial intermediaries, the legal background of their operation and the advantages inherent in them. Among others, this chapter provides insight into the indicators used for expressing the riskiness of a portfolio, and the asset-liability management that is a supporting tool for the co-ordination and planning of life insurance payments. There are minor or major differences between the pension systems in each country. However, this is not the only thing that makes their comparison difficult; the lack of a standard set of terms and common interpretation also exacerbates comparison. The authors, by clarifying the concepts and correlations relating to the pension systems, attempt to provide guidance in the interest of easier understanding.

Chapter 4 deals with the regulation of two large groups of institutions: banks and institutional investors. In banking regulations, the Basel Capital Accords (Basel I and Basel II) can be considered milestones. The biggest problem of the previous recommendations and requirements (prevailing prior to the outbreak of the crisis) is that they did not place enough emphasis on liquidity risk, they did not deal with securitisation, gave an excessively large role to unregulated credit rating agencies and ignored the pro-cyclical nature of regulations, which had been stressed for decades. Attempts are made to remedy the inadequacies listed above and make the activities of banks even more transparent within the framework of the Basel III regulation package. With regard to institutional investors, the starting point is that the risk appetite of their customers (savers) is greater and investors use them in the hope of gaining ever higher yields instead of putting their savings into bank deposits. Thus the epicentre of the regulations includes sufficient information, disclosure, transparent operation, enabling investors to assess the risks associated with the intermediary institution and the financial products offered by it based on the published information. The authors list the information and disclosure obligations of the three large institutional investor groups (life insurers, pension funds and investment funds) and present the latest regulatory challenges and developments.

As the authors conclude in *Chapter 5*, there is no standard financial supervisory structure in the world economy, despite this diversity, there are some features the existence of which is a primary requirement in the operation of the supervisory authorities. As financial services are provided across state borders, it is a justified requirement for financial supervisory authorities not to limit their activities only to a national scope. The legal background, at least on an EU level, has been partly established, and the elaboration and implementation of legal regulations are in progress. The co-ordination activities aiming at more effective co-operation and harmonisation of the activities of the national supervisory agencies are continuing based on the recommendations of the de Larosière report analysing the causes of the crisis.

The book, which is the latest addition to the finance-accounting series of the publisher, fits well with the previous books of the series [Pénzügy(rendszer)tan (*Financial (system) studies*); Pénzügyi piacok a globális térben (*Financial markets in a global environment*); Költségvetési pénzügyek (*Fiscal finances*)]. The professional, complex and balanced approach is accompanied with didactic, understandable and high-quality editing work. The book by Mihály Erdős and Katalin Mérő enriches Hungarian language financial literature and the available range of higher education textbooks.

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