FINANCIAL MARKETS AND INSTITUTIONS

OTHER FINANCIAL INSTITUTIONS

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AGENDA

- Mutuality and banking
- Finance companies

MUTUALITY AND BANKS

Wide differences exist across countries: we look at general similarities

- Historically, rural areas experienced an unmatched demand for funding in forms that today are called "microfinance": small operations, large numbers
- These institutions developed almost spontaneously in several forms:
  - from original urban (Schulze-Delitzsch, Luzzatti) and rural (Raiffeisen, Wollemborg) credit unions
  - to modern cooperative (savings) banks

MUTUALITY AND BANKS

Mutuality requires that customers and owners of the institution coincide:

- All deposits (ideally) represent equity, increasing funds' availability and lowering leverage risks
- Undistributable profits reduce excessive risk-taking incentives
- Rules on maximum share ownership cancel the risk of takeovers
- More agency issues between customers/owners and managers, but less incentives to profit from them
- More costs and less economies of scale
- Some weaknesses, enhanced by poor regulation and conflicts of interest with politics, lead to sectoral crises (f.i. 1980's S&L US crisis)
- Today more similarities than differences (products, regulation/supervision), yet cooperative aim remains and allows tax advantages, size and sophistication are smaller

MGCIs

A particular case for Mutual Guarantee Credit Institutions:

- mutuals, but providing their financial strength to members/customers by issuing guarantees, to be used as collateral in obtaining loans
- allow businesses (particularly SMEs) to access credit or to achieve better economic conditions on loans
- lack of deposits limits regulation; in some countries it is nonetheless similar to banks (f.i. Italy)
- risk pooling and peer-monitoring across members
- leverage of own and (especially) public funds

FINANCE COMPANIES

- Born as a source of installment credit for consumer purchases from retailers
- Specialised in particular customers (f.i. consumers) or products (f.i. leasing)
- Usually, funds are acquired in large volumes from money markets and used for short/medium term small lending:
  - Lower liquidity risk, due to the lack of deposits, yet they lack secondary markets for their assets
  - Lower IR risk, due to shorter terms, but still arising from mismatches between assets and liabilities
  - Higher credit risk, due to specialisation in less sound borrowers, only partially balanced by higher IR
  - Marginal regulatory constraints, due to the lack of deposits, except for consumer protection and disclosure requirements
- Often captives of other financial and non-financial institutions but also independent

FINANCE COMPANIES

Main types:

- business/commercial finance companies:
  - **factoring**: loans are provided as a discounted present value of a receivable account securing the loan (f.i. proceeding of goods sold), with or without recourse, also providing additional services (scrutiny of debtors, collection, …)
  - **leasing**: equipment is bought and leased to businesses providing at the same time collateral, allowing tax advantages for lessees
  - (revolving) **floor plan loans**: credit is granted on inventories of assets with titles, securing the loan through individual liens, each selling freeing part of the original loan
  - they can be **captives** of particular manufacturers/retailer

FINANCE COMPANIES

Main types:

- **consumer finance** companies:
  - allowing purchases of specific goods (furniture, TVs, …), home restructuring or refinance of previous debts
  - consumers have either difficulties in obtaining credit from normal channels or find convenient to have a one-stop-shop
  - specialisation allows collateralisation of items unacceptable from traditional channels
  - some provide retail credit cards
  - another specialisation is in more troubled borrowers (poor credit history, insufficient income, …)

FINANCE COMPANIES

High-risk borrowers of finance companies lead to high IR:

- with the typical issues of adverse selection and moral hazard
- with a frequent boundary represented by usury statutes:
  - aiming at banning excessive IR for consumer protection
  - requiring full disclosure of effective IR
  - usually differentiated by maturity, technical form, size of operation and based on mark-ups over average market rates
  - rigid ceilings disallow regulated entities from servicing (at their own risk) these customers, without significant effects on usury per se