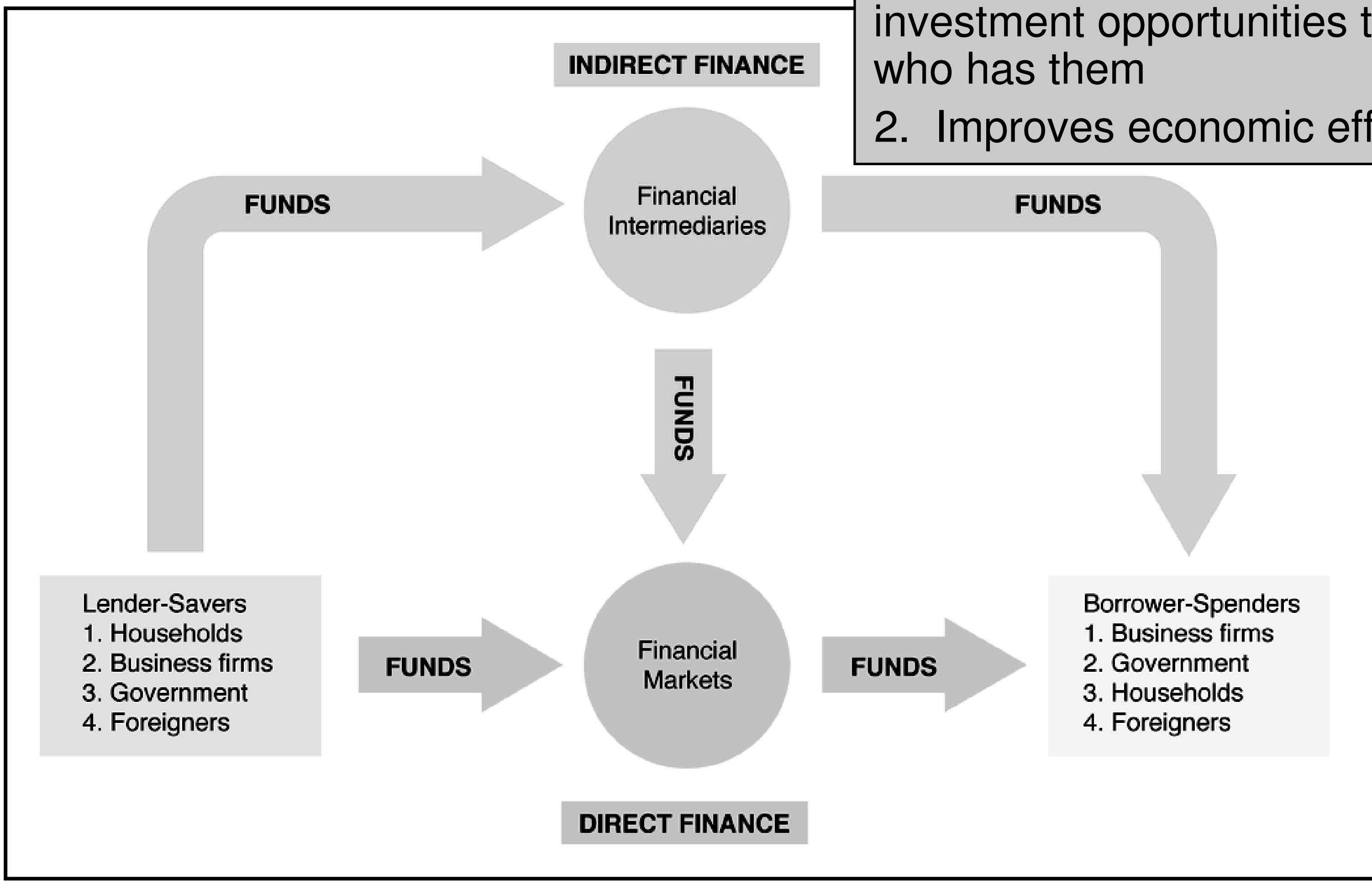
Chapter 2

An Overview of the Financial System

Function of Financial Markets

1. Allows transfers of funds from person or business without investment opportunities to one who has them
2. Improves economic efficiency



Classifications of Financial Markets

1. Debt markets
   - *maturity* = number of years until expiration date
     - short-term: maturity < 1 year
     - intermediate-term: maturity between 1 and 10 years
     - long-term: maturity > 10 years
   - typical examples: bonds, mortgages
2. Equity markets
   - common stocks – pay dividends, give voting rights, but owner is residual claimant

Although the average person is more aware of the equity market, the debt market is usually much larger.

Classifications of Financial Markets (cont.)

1. Primary market
   - new security issues sold to initial buyers – issuer receives "all" the proceedings
   - usually "behind closed doors" – investment banks underwrite securities (i.e., guarantee a price and then sell it to the public)
2. Secondary market
   - securities previously issued are bought and sold – issuers don't receive anything from the transaction
   - NYSE and NASDAQ are secondary markets; also forex markets, futures or options markets
   - *brokers* are agents of investors, matching buyers and sellers
   - dealers trade at stated prices

Liquidity of a financial instrument = the easiness to sell and raise cash

Classifications of Financial Markets (cont.)

1. *Exchanges*: trades conducted in central locations (e.g., New York Stock Exchange, Chicago Board of Trade)
2. *Over-the-counter markets*: dealers at different locations buy and sell (e.g., the U.S. government bond market)

1. *Money markets*: short-term instruments (maturity < 1 year) smaller price fluctuations, used for investments of temporary funds (corporations or banks)
2. *Capital markets:* longer-term instruments (long-term bonds) or stocks – usually held by insurance companies or pension funds

Internationalization of Financial Markets

- International bond market
  - trades in:
    - *foreign bonds* = bonds sold in a foreign country and denominated in that country's currency
    - *Eurobonds* = bonds denominated in a currency other than that of the country in which they are sold
  - a variant of Eurobonds is *Eurocurrencies* – deposits of foreign currency with foreign banks (e.g., Eurodollars are deposits of U.S. dollars with foreign banks)
  - now larger than U.S. corporate bond market

- World Stock Markets
  - U.S. stock markets are no longer always the largest: Japan sometimes larger

Activities of Financial Intermediaries

- financial intermediaries engage in process of indirect finance
- they are a more important source of finance than securities markets
- they are needed because of transactions costs and asymmetric information
- *transaction costs* = time and money spent in transactions

Activities of Financial Intermediaries (cont.)

- financial intermediaries make profits by reducing transactions costs through:
  - specialization (expertise)
  - economies of scale
- low transaction costs mean intermediaries can provide *liquidity services* – easier for customers to conduct transactions

Function of Financial Intermediaries

- *Risk sharing* = reduce exposure of investors to risk
  - create and sell assets with low risk characteristics and then use the funds to buy assets with more risk (also called *asset transformation*)
  - also lower risk by helping people to diversify portfolios

Asymmetric Information: Adverse Selection and Moral Hazard

- Adverse selection
  - *before* transaction occurs
  - potential borrowers most likely to produce adverse outcomes are the ones most likely to seek loans and be selected
- Moral hazard
  - *after* transaction occurs
  - hazard that borrower has incentives to engage in undesirable (immoral) activities making it more likely that won't pay loan back

Financial intermediaries reduce adverse selection and moral hazard problems, enabling them to make profits

Financial Intermediaries

Life insurance companies	Premiums from policies	Corporate bonds and mortgages
Fire and casualty insurance companies	Premiums from policies	Municipal bonds, corporate bonds and stock, U.S. government securities
Pension funds, government retirement funds	Employer and employee contributions	Corporate bonds and stock
Investment intermediaries		
Finance companies	Commercial paper, stocks, bonds	Consumer and business loans
Mutual funds	Shares	Stocks, bonds
Money market mutual funds	Shares	Money market instruments

Size of Financial Intermediaries

Table 2 Principal Financial Intermediaries and Value of Their Assets

Type of Intermediary	Value of Assets ($ billions, end of year) 1970	1980	1990	2002
Depository institutions (banks)				
Commercial banks	517	1,481	3,334	7,161
Savings and loan associations and mutual savings banks	250	792	1,365	1,338
Credit unions	18	67	215	553
Contractual savings institutions				
Life insurance companies	201	464	1,367	3,269
Fire and casualty insurance companies	50	182	533	894
Pension funds (private)	112	504	1,629	3,531
State and local government retirement funds	60	197	737	1,895
Investment intermediaries				
Finance companies	64	205	610	1,165
Mutual funds	47	70	654	3,419
Money market mutual funds	0	76	498	2,106

Source: Federal Reserve Flow of Funds Accounts: www.federalreserve.gov/releases/Z1/LevelTables.

Regulatory Agencies

Table 3 Principal Regulatory Agencies of the U.S. Financial System

Regulatory Agency	Subject of Regulation	Nature of Regulations
Securities and Exchange Commission (SEC)	Organized exchanges and financial markets	Requires disclosure of information, restricts insider trading
Commodities Futures Trading Commission (CFTC)	Futures market exchanges	Regulates procedures for trading in futures markets
Office of the Comptroller of the Currency	Federally chartered commercial banks	Charters and examines the books of federally chartered commercial banks and imposes restrictions on assets they can hold
National Credit Union Administration (NCUA)	Federally chartered credit unions	Charters and examines the books of federally chartered credit unions and imposes restrictions on assets they can hold
State banking and insurance commissions	State-chartered depository institutions	Charters and examines the books of state-chartered banks and insurance companies, imposes restrictions on assets they can hold, and imposes restrictions on branching

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Federal Deposit Insurance Corporation (FDIC)	Commercial banks, mutual savings banks, savings and loan associations	Provides insurance of up to $100,000 for each depositor at a bank, examines the books of insured banks, and imposes restrictions on assets they can hold
Federal Reserve System	All depository institutions	Examines the books of commercial banks that are members of the system, sets reserve requirements for all banks
Office of Thrift Supervision	Savings and loan associations	Examines the books of savings and loan associations, imposes restrictions on assets they can hold
State banking and insurance commissions	State-chartered depository institutions	Charters and examines the books of state-chartered banks and insurance companies, imposes restrictions on assets they can hold, and imposes restrictions on branching

Regulation of Financial Markets – Main Reasons

- Increase information to investors
  - decreases adverse selection and moral hazard problems
  - SEC forces corporations to disclose information
- Ensuring the soundness of financial intermediaries
  - prevents financial panics
  - chartering, reporting requirements, restrictions on assets and activities, deposit insurance, and anti-competitive measures