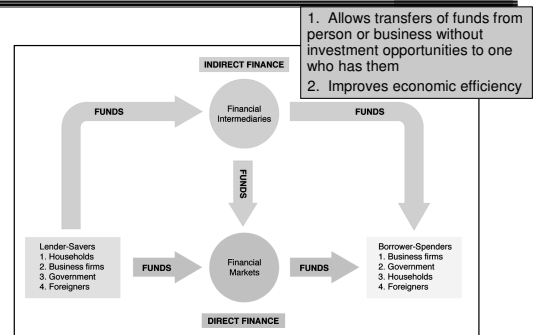


Chapter 2

An Overview of the Financial System

Function of Financial Markets



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.

2-3

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

2-4

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

2-5

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

2-6

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

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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

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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

2-9

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

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Financial Intermediaries

Table 1 Primary Assets and Liabilities of Financial Intermediaries

| Type of Intermediary | Primary Liabilities (Sources of Funds) | Primary Assets (Uses of Funds) |
|--|--|--|
| Depository institutions (banks) | | |
| Commercial banks | Deposits | Business and consumer loans, mortgages, U.S. government securities and municipal bonds |
| Savings and loan associations | Deposits | Mortgages |
| Mutual savings banks | Deposits | Mortgages |
| Credit unions | Deposits | Consumer loans |
| Contractual savings institutions | | |
| 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 |

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Size of Financial Intermediaries

Table 2 Principal Financial Intermediaries and Value of Their Assets

| Type of Intermediary | 1970 | Value of Assets (\$ billions, end of year) | | 2002 |
|--|------|--|-------|-------|
| | | 1980 | 1990 | |
| 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/Z11/level/tables.

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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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Regulatory Agencies

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

| Regulatory Agency | Subject of Regulation | Nature of Regulations |
|--|---|---|
| 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 |

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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

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