Chapter 1:

Role of Financial Markets and Institutions

Topics of Discussion

- Basic Terminologies
- Overview and Importance of Financial System / Environment
- Securities Traded in Financial Markets
- Role of Financial Markets
- Role of Financial Institutions
- Regulations in the Financial System
- Globalization, Innovations and Technological Transformations
- Why Study Financial Securities, Markets and Institutions?

Basic Terminologies

Investment

The commitment of funds to one or more assets that will be held over some future time period is called investment.

Investments

The study of the investment process is called investments.

Financial Assets

- Pieces of paper evidencing a claim on some issuer is called financial assets.
- A paper (or electronic) claim on some issuer is called financial assets.

Real Assets

The physical/tangible assets such as gold, silver, diamond and real estate etc are called real assets.

Basic Terminologies

Marketable Securities:

- Financial assets that are easily traded in organized market is called marketable securities.

Liquidity:

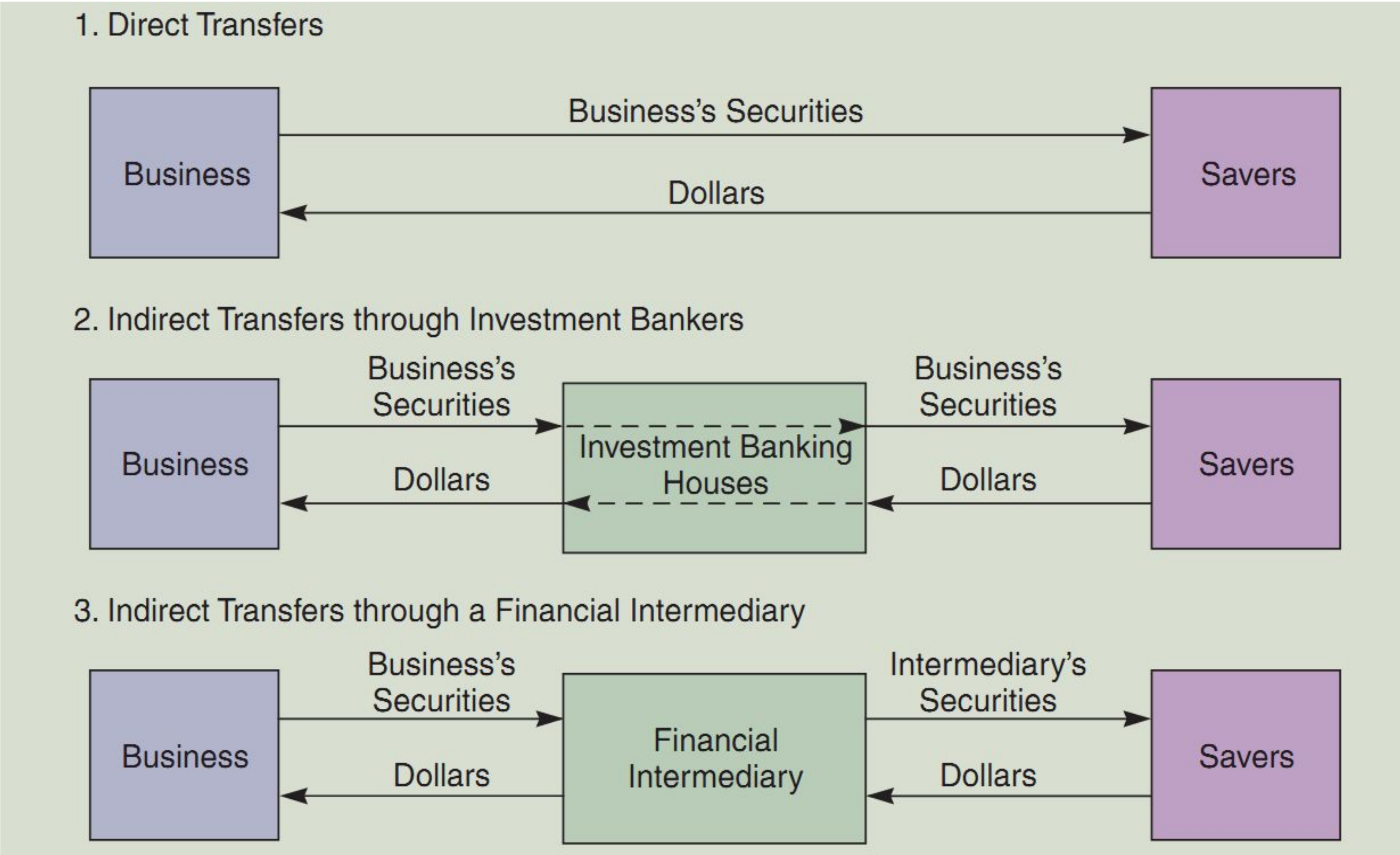
The ease with in which an asset can be bought or sold with relatively low price change is called liquidity. There are two conditions for the liquid assts:

1. Easily convertible into cash
2. With relatively low price change

An Overview of Financial System

- A financial system is a system that allows the exchange of funds between lenders, investors, and borrowers.
- In other words, a system in which funds/capital flow from savers/lenders to users/borrowers efficiently for the most productive uses.
- Major components of the financial system
  - Financial securities/ instruments /assets
  - Financial markets
  - Financial institutions
- Surplus & Deficit Units: Household/Individual, Business and Government
  - Surplus units: participants who receive more money than they spend, such as investors.
  - Deficit units: participants who spend more money than they receive, such as borrowers.
- Financing and Investment needs/decisions
- Financial systems operate at national, global, and firm-specific levels. They consist of complex, closely related services, markets, and institutions intended to provide an efficient and regular linkage between investors and depositors.
- A well-functioning financial system is essential for stable economic growth.

Transfer of Capital from Savers to Borrowers



Transfer of Capital from Savers to Borrowers

- Direct transfer (e.g., corporation issues shares commercial papers to insurance companies).
- Indirect transfer through an investment banking house (e.g., IPO, seasoned equity offering, or debt placement). Investment banks merely transfer securities (claims) for a margin/fees.
- Indirect transfer through a financial intermediary (e.g., individual deposits money in bank, bank makes commercial loan to a company). Financial intermediaries create their own securities (claims).

Securities Traded in Financial Markets

- Money market securities
  - **Money market securities** are debt securities with a maturity of one year or less
  - Characteristics:
    - Liquid
    - Low expected return
    - Low degree of risk

Securities Traded in Financial Markets (cont'd)

- Capital market securities
  - **Capital market securities** are those with a maturity of more than one year
    - Bonds and mortgages
    - Stocks
  - Capital market securities have a higher expected return and more risk than money market securities

Securities Traded in Financial Markets (cont'd)

- Bonds and mortgages
  - Bonds are long-term debt obligations issued by corporations and government agencies
  - Mortgages are long-term debt obligations created to finance the purchase of real estate
  - Bonds and mortgages specify the amount and timing of interest and principal payments

Securities Traded in Financial Markets (cont'd)

- Stocks
  - Stocks (equity) are certificates representing partial ownership in corporations
  - Investors may earn a return by receiving dividends and capital gains
  - Stocks have a higher expected return and higher risk than long-term debt securities

Securities Traded in Financial Markets (cont'd)

- Derivative securities
  - **Derivative securities** are financial contracts whose values are derived from the values of underlying assets
  - **Speculating** with derivatives allow investors to benefit from increases or decreases in the underlying asset
  - **Risk management** with derivatives generates gains if the value of the underlying security declines

Overview of Financial Markets

- A **financial market** is a market in which financial assets (securities) can be purchased or sold

- Financial markets facilitate financing and investing by households, firms, and government agencies
  - Participants that provide funds are called **surplus units**
    - e.g., households, businesses, the government
  - Participants that enter markets to obtain funds are **deficit units**
    - e.g., households, businesses, the government

- A major participant in financial markets is the Fed, because it controls the money supply

Types of Financial Markets

- Financial markets can be distinguished by the maturity structure and trading structure of its securities

- Money versus capital markets
  - The flow of short-term funds is facilitated by **money markets**
  - The flow of long-term funds is facilitated by **capital markets**

- Primary versus secondary markets
  - **Primary markets** facilitate the issuance of new securities
    - e.g., the sale of new corporate stock or new Treasury securities
  - **Secondary markets** facilitate the trading of existing securities
    - e.g., the sale of existing stock
    - Securities traded in secondary markets should be **liquid**

Types of Financial Markets (cont'd)

- Organized versus over-the-counter markets
  - A visible marketplace for secondary market transactions is an **organized exchange**
  - Some transactions occur in the **over-the-counter (OTC)** market (a telecommunications network)
- Knowledge of financial markets is power
  - Decide which markets to use to achieve our investment goals or financing needs
  - Decide which markets to use as part of your job
  - Avoid common mistakes in investing and borrowing

Valuation of Securities in Financial Markets

- Securities are valued as the present value of their expected cash flows, discounted at a rate that reflects their uncertainty
- Market pricing of securities
  - Different investors may value the same security differently based on their interpretation of information
- Impact of valuations on pricing
  - Every security has an equilibrium market price at which demand and supply for the security are equal
    - Favorable information results in upward valuation revisions; unfavorable information results in downward revisions
  - Securities reach a new equilibrium price as new information becomes available

Valuation of Securities in Financial Markets (cont'd)

- Impact of the Internet on the valuation process
  - The valuation of securities is improved as a result of the internet because of
    - Online price quotations
    - Increased information about firms issuing securities
    - Online orders to buy or sell securities

Market Efficiency

- Markets are **efficient** when security prices fully reflect all available information

- In an efficient market, different investors may still prefer different securities because of differences in:
  - Risk preference
  - Desired liquidity
  - Tax status

Market Efficiency (cont'd)

- Impact of asymmetric information
  - **Asymmetric information** is information a firm's managers have that is not available to investors
  - The valuation process is influenced by the financial statements that are used to derive cash flow estimates
  - Securities may be mispriced because of
    - Flexibility in accounting guidelines
    - Overestimation of earnings
  - The asymmetric information problem can be reduced if managers frequently disclose financial data and information to the public or through increased regulation

Financial Market Regulation

- Many regulations attempt to ensure that businesses disclose accurate information
- Disclosure
  - The Securities Act of 1933 intended to ensure complete disclosure of relevant financial information on publicly offered securities
  - The Securities Exchange Act of 1934 extended the disclosure requirements to secondary market issues

Financial Market Regulation (cont'd)

- Regulatory response to financial scandals
  - Enron, WorldCom and other scandals involved
    - Exaggerated earnings
    - Failure to disclose relevant information
    - Auditors not meeting their responsibilities
  - Existing regulations were not completely preventing fraud

Financial Market Regulation (cont'd)

- Increased regulation is existing or emerging in these areas:
  - Provision of more complete and accurate financial information
  - More restrictions to ensure proper auditing by auditors
  - Proper oversight by the firm's board of directors

Global Financial Markets

- Financial markets vary among countries in terms of
  - The volume of funds that are transferred from surplus to deficit units
  - The types of funding that are available

- How financial markets influence economic development
  - Many foreign countries have converted to market-oriented economies
    - Allows businesses and consumers to obtain financing
  - Many Eastern European countries allowed for **privatization**, the sale of government-owned firms to individuals
    - Financial markets in these countries ensure that businesses can obtain funding from surplus units

Global Financial Markets (cont'd)

- Global integration
  - Many financial markets are globally integrated
    - Participants move funds out of one country's market and into another
    - Foreign investors serve as key surplus units in the U.S. by purchasing securities
    - U.S. investors serve as key surplus units for foreign countries by purchasing foreign securities
  - Market movements and interest rates have become more correlated between markets

Global Financial Markets (cont’d)

- Global integration (cont’d)
  - Barriers to global integration
    - Lack of information about foreign companies
    - Different accounting regulation
    - Excessive cost of executing international transactions

Global Financial Markets (cont'd)

- Role of the foreign exchange market
  - The **foreign exchange market** facilitates the exchange of currencies
  - Financial intermediaries serve as brokers and/or dealers in foreign exchange markets
  - Foreign exchange market
    - The exchange rate is the market-determined price of a currency
      - Price changes in response to supply and demand

Role of Financial Institutions in Financial Markets

- In a **perfect** market:
  - All information about any securities for sale in primary and secondary markets would be continuously and freely available to all investors
  - All information identifying investors interested in purchasing securities as well as investors planning to sell securities would be freely available
  - All securities are infinitely divisible
- Markets are **imperfect**
  - Financial institutions are needed to resolve problems created by market imperfections

Role of Financial Institutions in Financial Markets (cont'd)

- Role of depository institutions
  - Depository institutions accept deposits from surplus units and provide credit to deficit units
  - Depository institutions are popular because:
    - Deposits are liquid
    - They customize loans
    - They accept the risk of loans
    - They have expertise in evaluating creditworthiness
    - They diversify their loans

Role of Financial Institutions in Financial Markets (cont'd)

- Commercial banks
  - Are the most dominant depository institution
  - Offer a wide variety of deposit accounts
  - Transfer deposited funds by providing direct loans or purchasing debt securities
  - Serve both the public and the private sector

Role of Financial Institutions in Financial Markets (cont'd)

- Savings institutions
  - Include savings and loan associations (S&Ls) and savings banks
  - Are mostly owned by depositors (mutual)
  - Concentrate on residential mortgage loans

- Credit unions
  - Are nonprofit organizations
  - Restrict their business to credit union members
  - Tend to be much smaller than other depository institutions

Role of Financial Institutions in Financial Markets (cont'd)

- Role of non-depository financial institutions
  - Non-depository institutions generate funds from sources other than deposits
  - Finance companies
    - Obtain funds by issuing securities
    - Lend funds to individuals and small businesses

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Role of Financial Institutions in Financial Markets (cont'd)

- Mutual funds (lets talk about that in later chapter)
  - Sell shares to surplus units
  - Use funds to purchase a portfolio of securities
    - Some focus on capital market securities (e.g., stocks or bonds)
    - **Money market mutual funds** concentrate on money market securities

Role of Financial Institutions in Financial Markets (cont'd)

- Securities firms (lets talk about that in later chapter)
  - **Broker** function
    - Execute securities transactions between two parties
    - Charge a fee in the form of a Investment banking function
    - **Underwrite** newly issued securities
  - **Dealer** function
    - Securities firms make a market in specific securities by adjusting their inventory
    - **bid-ask spread**

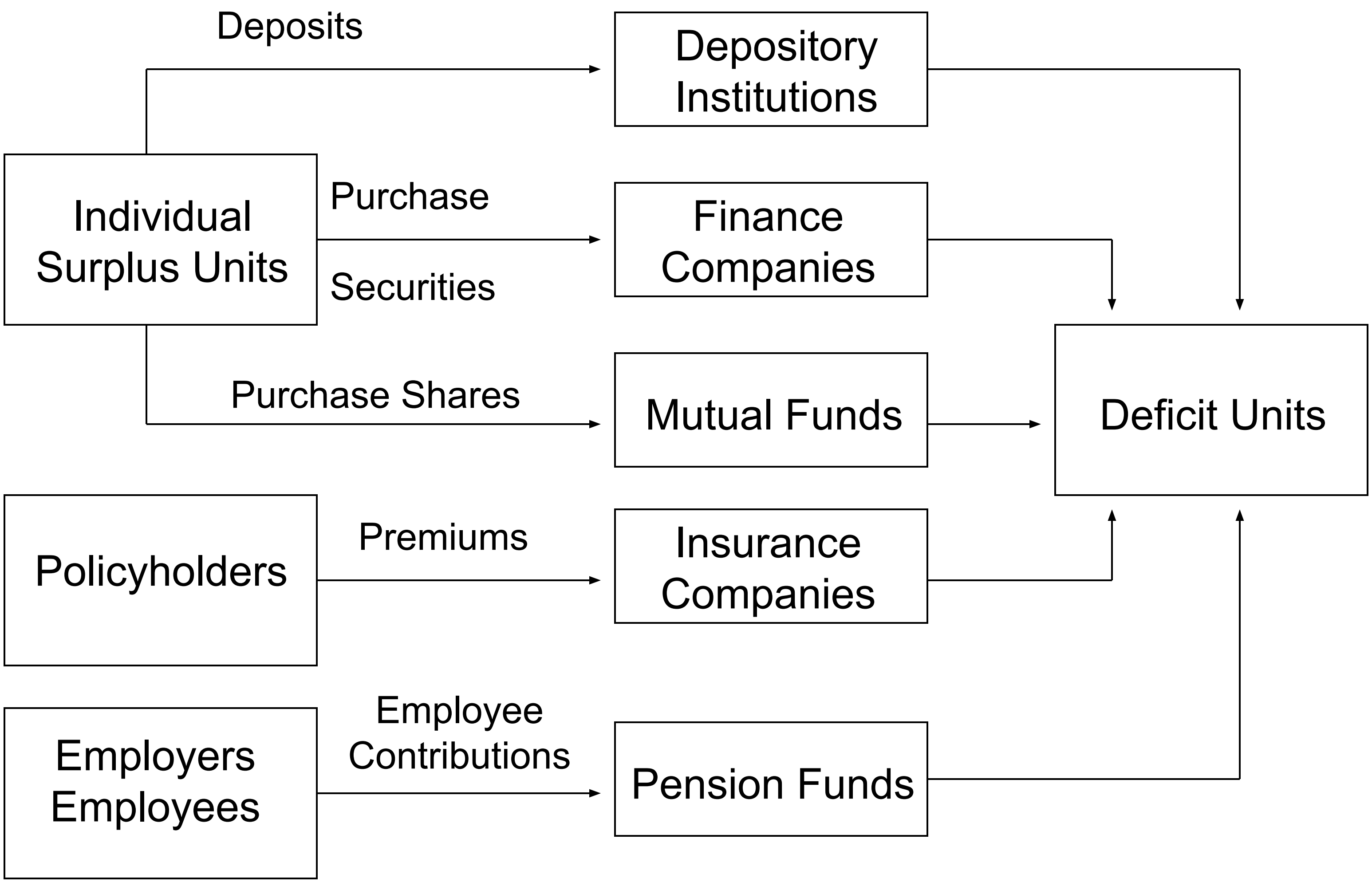
Role of Financial Institutions in Financial Markets (cont’d)

- Insurance companies (lets talk about that in later chapter)
  - Provide insurance policies to individuals and firms for death, illness, and damage to property
  - Charge premiums
  - Invest in stocks or bonds issued by corporations

Role of Financial Institutions in Financial Markets (cont'd)

- Pension funds (lets talk about that in later chapter)
  - Offered by most corporations and government agencies
  - Manage funds until they are withdrawn from the retirement account
  - Invest in stocks or bonds issued by corporations or in bonds issued by the government

Comparison of Roles among Financial Institutions



Overview of Financial Institutions

- Competition between financial institutions
  - Financial institutions should operate to maximize the value of their owners
    - Present value of future cash flows
  - Depends on:
    - Growth and profitability
    - Degree of risk

Overview of Financial Institutions (cont'd)

- Competition between financial institutions (cont'd)
  - Impact of the internet on competition
    - Online commercial banks
      - Lower costs and higher interest rates
    - Online services by banks
      - Reduces costs and increases efficiency
    - Online insurance companies
      - Reduces operating costs
    - Online brokerage firms
      - Reduces operating costs and fees

Overview of Financial Institutions (cont'd)

- Consolidation of financial institutions
  - Reduction in regulations has resulted in more opportunities to capitalize on:
    - Economies of scale
    - Economies of scope
  - Mergers have resulted in financial conglomerates
  - Consolidation may increase expected cash flows or reduce risk, or both

Global Expansion by Financial Institutions

Various financial institutions have expanded through international mergers, resulting in:

More services to clients	An international customer base

The introduction of the euro has increased international mergers

Credit Crisis for Financial Institutions

- Systemic Risk during the Credit Crisis 2007 - 2008
- Government Response to the Credit Crisis
  - Emergency Economic Stabilization Act
  - Federal Reserve Actions
  - Financial Reform Act of 2010