# Financial Institutions and System

## Week 2: An Overview of the Financial System

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# Agenda

1. An Overview of the Financial System
2. Class Discussion: Financial Markets and Institutions
3. Class Activity: The 2008 Financial Crisis and the Role of Financial Institutions

# 1. An Overview of the Financial System

## Function of Financial Markets

- Channel funds from economic players with **surplus funds** to those in need.
- **Direct finance**: Borrowers sell **securities** directly to lenders.

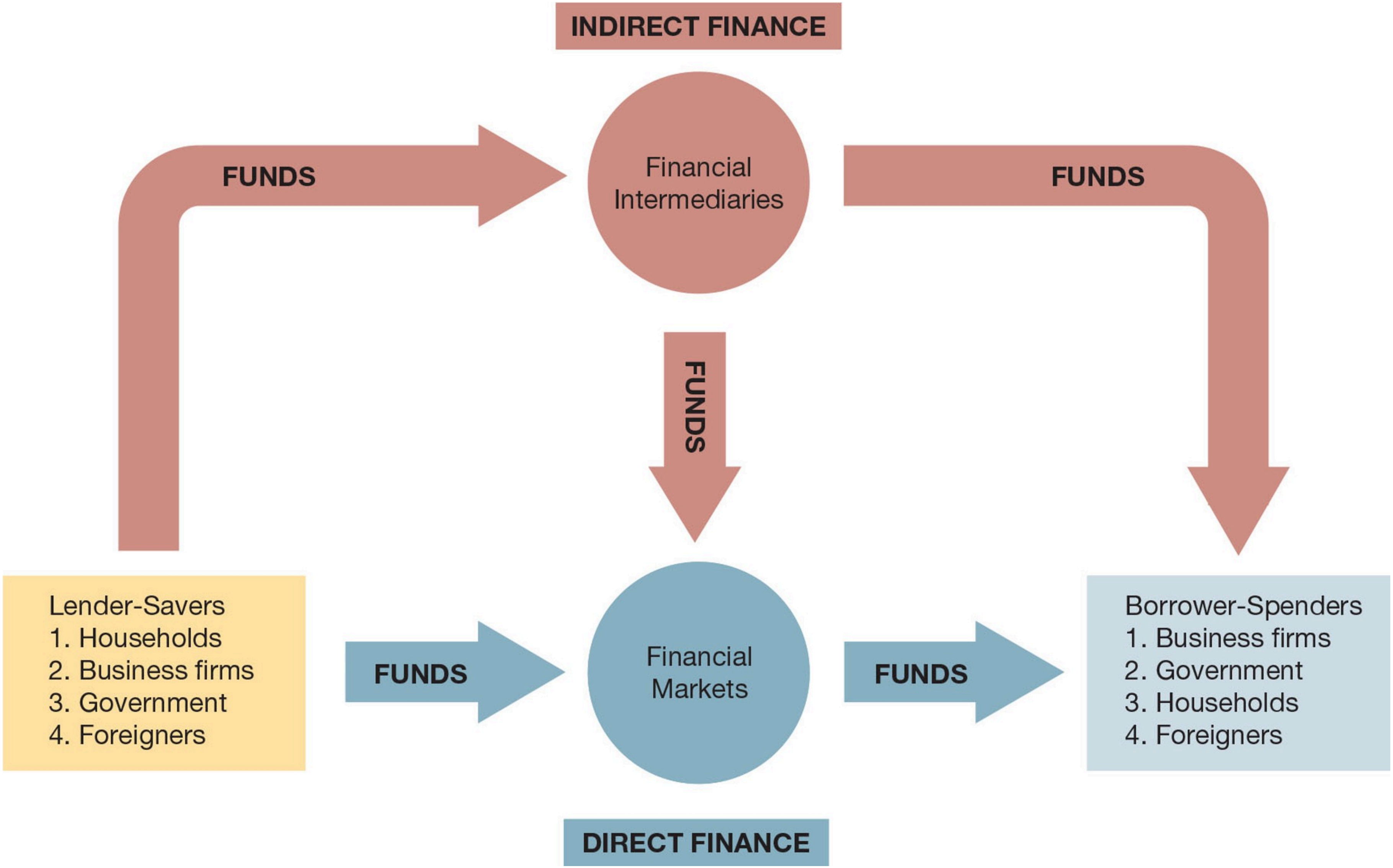
### Why is this important?

- **Promotes economic efficiency** by ensuring capital allocation.
- **Improves consumer well-being** by optimizing purchase timing.
- **Enhances economic growth** by making capital available to productive investments.

### Key Activities in Financial Markets:

- Facilitate the trading of **bonds and stocks**.
- Affect **personal wealth, business growth, and economic stability**.
- Play a crucial role during **financial crises**, impacting economies worldwide.

# Flows of Funds Through the Financial System



# Structure of Financial Markets

## Two Ways to Obtain Funds

1. **Debt Markets**
    - Borrowers issue **debt instruments** (loans, bonds) with fixed payments.
    - **Maturity**: The number of years until repayment.
    - **Short-term vs. long-term debt instruments**.
2. **Equity Markets**
    - Investors hold **shares** in a company's net income and assets.
    - **Dividends, voting rights**, and ownership advantages.
    - **Residual claimants** – Equity holders get paid after debt holders.

## Debt vs. Equity

- **Debt holders** receive fixed payments and get priority over equity holders.
- **Equity holders** benefit from increases in the corporation's profitability.
- **Key differences:** Risk, ownership rights, and potential returns.

# Primary and Secondary Markets

- **Primary Market**
  - New securities are sold to initial buyers (e.g., **IPOs**).
  - Investment banks **underwrite** securities.
  - Transactions are **not open to the public**.
- **Secondary Market**
  - Securities that have been previously issued are **resold**.
  - **Brokers** match buyers with sellers.
  - **Dealers** buy and sell securities at stated prices.
  - Helps in **price discovery and liquidity provision**.

## Why Secondary Markets Matter

- **Firms raise funds only in the primary market**, but...
- Secondary markets:
  - **Improve liquidity** (easier buying and selling).
  - **Determine security prices**, impacting primary market valuations.
  - Support **financial stability and investment decisions**.

# Types of Secondary Markets

1. **Exchanges** – Buyers and sellers meet at a centralized location.
   - *Examples:* NYSE, Chicago Board of Trade.
2. **Over-the-Counter (OTC) Markets** – Dealers buy and sell securities remotely.
   - *Examples:* Foreign Exchange (Forex), Federal Funds market.
   - Operate **without centralized exchanges**.

# Money and Capital Markets

- **Money Market** – Short-term debt instruments, high liquidity.
- **Capital Market** – Long-term debt and equity securities.

## Why it matters?

- Money markets provide short-term funding for corporations and governments.
- Capital markets allow firms to finance **long-term growth and investment**.

# Financial Market Instruments

## Table 1 Principal Money Market Instruments

| Type of Instrument | Amount ($ billions, end of year) 1990 | Amount ($ billions, end of year) 2000 | Amount ($ billions, end of year) 2010 | Amount ($ billions, end of year) 2019 |
|---|---|---|---|---|
| U.S. Treasury bills | 527 | 647 | 1,767 | 2,416 |
| Negotiable bank certificates of deposit (large denominations) | 547 | 1,053 | 1,923 | 1,859 |
| Commercial paper | 558 | 1,602 | 1,058 | 1,045 |
| Federal funds and security repurchase agreements | 372 | 1,197 | 3,598 | 4,356 |

**Source:** Federal Reserve Financial Accounts of the United States: https://www.federalreserve.gov/releases/Z1

# Internationalization of Financial Markets

- **Foreign Bonds** – Issued in a foreign country in that country's currency.
- **Eurobonds** – Issued in a currency **other than** the country's own.
- **Eurocurrencies** – Deposited foreign currencies outside their home country.
  - *Example:* **Eurodollars** – USD deposits in non-U.S. banks.
- **Increasing integration of global financial markets** impacts monetary policy worldwide.

## Financial Intermediaries: Indirect Finance

- **Financial intermediaries** connect savers with borrowers.
- **Reduce asymmetric information problems** in markets.
- Primary route for **fund transfers** in financial markets.

### Why Important?

- **Lower transaction costs** and improve **efficiency**.
- **Facilitate risk sharing** through financial instruments.

# Transaction Costs & Risk

- **Transaction costs** – Time and money spent in financial transactions.
  - **Economies of scale** lower costs for intermediaries.
- **Risk** – Uncertainty of investment returns.
  - Financial institutions **diversify risk** through asset transformation.

## Asymmetric Information

- **One party has more knowledge than the other.**
- **Financial intermediaries help by:**
  - **Adverse Selection** – Screening risky borrowers before lending.
  - **Moral Hazard** – Ensuring borrowers act responsibly **after** receiving funds.

# Types of Financial Intermediaries

- **Depository Institutions** – Banks, credit unions, savings associations.
- **Contractual Savings Institutions** – Pension funds, insurance companies.
- **Investment Intermediaries** – Mutual funds, hedge funds, venture capital firms.

# Regulation of the Financial System

## Why regulate financial markets?

1. **Increase transparency** for investors.
2. **Ensure financial system stability**.
3. **Protect consumers from fraud and mismanagement**.

Financial regulations aim to **ensure market stability, protect consumers, and prevent systemic risks**.

Below are key areas of regulation along with notable legislative frameworks.

# Regulation of the Financial System (Cont'd)

## 1. Market Integrity & Investor Protection

- **Insider Trading Prevention** – Restricts unfair trading based on non-public information (*SEC rules*).
- **Financial Market Transparency** – Mandates corporate disclosures and accounting standards (*Sarbanes-Oxley Act*).
- **Credit Rating Agency Oversight** – Increases accountability for rating agencies (*Dodd-Frank Act*).

## 2. Risk Management & Financial Stability

- **Capital Requirements** – Ensures banks hold sufficient reserves (*Basel Accords*).
- **Liquidity Requirements** – Mandates adequate short-term funding to prevent crises (*Basel Accords*).
- **Stress Testing** – Regularly assesses banks' resilience to economic shocks (*Dodd-Frank Act*).
- **Derivatives Regulation** – Enhances transparency in complex financial products (*Dodd-Frank Act*).

# Regulation of the Financial System (Cont'd)

## 3. Consumer Protection & Fair Lending

- **Truth in Lending Act (TILA)** – Ensures transparency in loan agreements and interest rates.
- **Anti-Money Laundering (AML) Rules** – Prevents financial crimes and terrorist financing (*Bank Secrecy Act*).
- **Deposit Insurance** – Protects consumers' bank deposits from failures (*FDIC rules*).

## 4. Systemic Risk & Crisis Management

- **Systemic Risk Oversight** – Introduces regulation for "too-big-to-fail" institutions (*Dodd-Frank Act*).
- **Financial Institution Resolution & Living Wills** – Requires large banks to outline failure contingency plans (*Dodd-Frank Act*).

## 5. Monetary Policy & Global Coordination

- **Monetary Policy Regulation** – Governs money supply and interest rates (*Federal Reserve Act*).
- **International Banking Standards** – Ensures global financial stability (*Basel Accords*).

# Government Regulation of Financial Institutions

## **Table 5** 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 and thrift institutions | Charters and examines the books of federally chartered commercial banks and thrift institutions; 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 |

# Overview of the Financial System: Summary

The financial system **facilitates the flow of funds** between savers and borrowers, ensuring economic efficiency and stability.

## Key Functions

- **Capital Allocation** – Transfers funds from surplus units (savers) to deficit units (borrowers).
- **Risk Management** – Enables risk-sharing through diversification and hedging instruments.
- **Liquidity Provision** – Ensures the ability to buy/sell financial assets easily.
- **Monetary Transmission** – Channels central bank policies into the economy.

## Main Components

1. **Financial Markets** – Includes money markets (short-term) & capital markets (long-term).
2. **Financial Institutions** – Banks, insurers, mutual funds, and pension funds.
3. **Financial Instruments** – Debt (bonds), equity (stocks), and derivatives.
4. **Regulatory Framework** – Ensures stability and investor protection.

## Why It Matters?

- Drives **economic growth**
- Supports **investment & innovation**
- Maintains **financial stability**

# 2. Class Discussion: Financial Markets and Institutions

# Group Activity: Financial Markets and Institutions

## Discussion & Brainstorming

**Topic:** *The Role of Financial Markets and Institutions in the Economy*

**Key Questions:**

- How do **financial markets** facilitate capital allocation and economic growth?
- In what ways do **financial intermediaries** reduce **transaction costs** and **manage risk**?
- Why is **regulation** crucial for financial stability and investor protection?
- What are the **risks** associated with financial markets and institutions?
- How can financial institutions **mitigate risks** and **ensure market integrity**?
- What are the **benefits** and **challenges** of international financial markets?

# 3. Class Activity: The 2008 Financial Crisis and the Role of Financial Institutions

# Any QUESTIONS?

## Thank You!

# Next Class

- (Mar 21) Chap 3. What is money?