FINANCIAL MARKETS AND INSTITUTIONS

A financial market is a market in which people trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds, and commodities include precious metals or agricultural goods.

In economics, typically, the term *market* means the aggregate of possible buyers and sellers of a certain good or service and the transactions between them.

The term "market" is sometimes used for what are more strictly *exchanges*, organizations that facilitate the trade in financial securities, e.g., a stock exchange or commodity exchange. This may be a physical location (like the NYSE, BSE, NSE) or an electronic system (like NASDAQ). Much trading of stocks takes place on an exchange; still, corporate actions (merger, spinoff) are outside an exchange, while any two companies or people, for whatever reason, may agree to sell stock from the one to the other without using an exchange.

Trading of currencies and bonds is largely on a bilateral basis, although some bonds trade on a stock exchange, and people are building electronic systems for these as well, similar to stock exchanges.

Types of financial markets

Within the financial sector, the term "financial markets" is often used to refer just to the markets that are used to raise finance: for long term finance, the ***Capital markets***; for short term finance, the ***Money markets***.

- **Capital markets** which consist of:
    - Stock markets, which provide financing through the issuance of shares or common stock, and enable the subsequent trading thereof.
    - Bond markets, which provide financing through the issuance of bonds, and enable the subsequent trading thereof.
- **Commodity markets**, which facilitate the trading of commodities.
- **Money markets**, which provide short term debt financing and investment.
- **Derivatives markets**, which provide instruments for the management of financial risk.
- **Futures markets**, which provide standardized forward contracts for trading products at some future date.
- **Insurance markets**, which facilitate the redistribution of various risks.
- **Foreign exchange markets,** which facilitate the trading of foreign exchange.

The capital markets may also be divided into primary markets and secondary markets. Newly formed (issued) securities are bought or sold in primary markets, such as during initial public offerings. Secondary markets allow investors to buy and sell existing securities. The transactions in primary markets exist between issuers and investors, while secondary market transactions exist among investors.

Liquidity is a crucial aspect of securities that are traded in secondary markets. Liquidity refers to the ease with which a security can be sold without a loss of value. Securities with an active secondary market mean that there are many buyers and sellers at a given point in time. Investors benefit from liquid securities because they can sell their assets whenever they want; an illiquid security may force the seller to get rid of their asset at a large discount.

Types Of Financial Markets And Their Roles

A financial market is a broad term describing any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives. Financial markets are typically defined by having transparent pricing, basic regulations on trading, costs and fees, and market forces determining the prices of securities that trade.

Financial markets can be found in nearly every nation in the world. Some are very small, with only a few participants, while others - like the New York Stock Exchange (NYSE) and the forex markets - trade trillions of dollars daily.

Investors have access to a large number of financial markets and exchanges representing a vast array of financial products. Some of these markets have always been open to private investors; others remained the exclusive domain of major international banks and financial professionals until the very end of the twentieth century.

Capital Markets

A capital market is one in which individuals and institutions trade financial securities. Organizations and institutions in the public and private sectors also often sell securities on the capital markets in order to raise funds. Thus, this type of market is composed of both the primary and secondary markets.

Any government or corporation requires capital (funds) to finance its operations and to engage in its own long-term investments. To do this, a company raises money through the sale of securities - stocks and bonds in the company's name. These are bought and sold in the capital markets.

Stock-Markets

Stock markets allow investors to buy and sell shares in publicly traded companies. They are one of the most vital areas of a market economy as they provide companies with access to capital and investors with a slice of ownership in the company and the potential of gains based on the company's future performance.

This market can be split into two main sections: the primary market and the secondary market. The primary market is where new issues are first offered, with any subsequent trading going on in the secondary market.

Bond-Markets

A bond is a debt investment in which an investor loans money to an entity (corporate or governmental), which borrows the funds for a defined period of time at a fixed interest rate. Bonds are used by companies, municipalities, states and U.S. and foreign governments to finance a variety of projects and activities. Bonds can be bought and sold by investors on credit markets around the world. This market is alternatively referred to as the debt, credit or fixed-income market. It is much larger in nominal terms that the world's stock markets. The main categories of bonds are corporate bonds, municipal bonds, and U.S. Treasury bonds, notes and bills, which are collectively referred to as simply "Treasuries."

Money-Market

The money market is a segment of the financial market in which financial instruments with high liquidity and very short maturities are traded. The money market is used by participants as a means for borrowing and lending in the short term, from several days to just under a year. Money market securities consist of negotiable certificates of deposit(CDs), banker's acceptances, U.S. Treasury bills, commercial paper, municipal notes, eurodollars, federal funds and repurchase agreements (repos). Money market investments are also called cash investments because of their short maturities.

The money market is used by a wide array of participants, from a company raising money by selling commercial paper into the market to an investor purchasing CDs as a safe place to park money in the short term. The money market is typically seen as a safe place to put money due the highly liquid nature of the securities and short maturities.Because they are extremely conservative, money market securities offer significantly lower returns than most other securities. However, there are risks in the money market that any investor needs to be aware of, including the risk of default on securities such as commercial paper.

Cash-or-Spot-Market

Investing in the cash or "spot" market is highly sophisticated, with opportunities for both big losses and big gains. In the cash market, goods are sold for cash and are delivered immediately. By the same token, contracts bought and sold on the spot market are immediately effective. Prices are settled in cash "on the spot" at current market prices. This is notably different from other markets, in which trades are determined at forward prices.

The cash market is complex and delicate, and generally not suitable for inexperienced traders. The cash markets tend to be dominated by so-called institutional market players such as hedge funds, limited partnerships and corporate investors. The very nature of the products traded requires access to far-reaching, detailed information and a high level of macroeconomic analysis and trading skills.

Derivatives-Markets

The derivative is named so for a reason: its value is derived from its underlying asset or assets. A derivative is a contract, but in this case the contract price is determined by the market price of the core asset. If that sounds complicated, it's because it is. The derivatives market adds yet another layer of complexity and is therefore not ideal for inexperienced traders looking to speculate. However, it can be used quite effectively as part of a risk management program.

Examples of common derivatives are forwards, futures, options, swaps and contracts-for-difference (CFDs). Not only are these instruments complex but so too are the strategies deployed by this market's participants. There are also many derivatives, structured products and collateralized obligations available, mainly in the over-the-counter (non-exchange) market, that professional investors, institutions and hedge fund managers use to varying degrees but that play an insignificant role in private investing.

Forex-and-the-Inter-bank-Market

The interbank market is the financial system and trading of currencies among banks and financial institutions, excluding retail investors and smaller trading parties. While some interbank trading is performed by banks on behalf of large customers, most interbank trading takes place from the banks' own accounts.

The forex market is where currencies are traded. The forex market is the largest, most liquid market in the world with an average traded value that exceeds $1.9 trillion per day and includes all of the currencies in the world. The forex is the largest market in the world in terms of the total cash value traded, and any person, firm or country may participate in this market.

There is no central marketplace for currency exchange; trade is conducted over the counter. The forex market is open 24 hours a day, five days a week and currencies are traded worldwide among the major financial centers of London, New York, Tokyo, Zürich, Frankfurt, Hong Kong, Singapore, Paris and Sydney.

Until recently, forex trading in the currency market had largely been the domain of large financial institutions, corporations, central banks, hedge funds and extremely wealthy individuals. The emergence of the internet has changed all of this, and now it is possible for average investors to buy and sell currencies easily with the click of a mouse through online brokerage accounts.

Primary-Markets-vs.-Secondary-Markets

A primary market issues new securities on an exchange. Companies, governments and other groups obtain financing through debt or equity based securities. Primary markets, also known as "new issue markets," are facilitated by underwriting groups, which consist of investment banks that will set a beginning price range for a given security and then oversee its sale directly to investors.

The primary markets are where investors have their first chance to participate in a new security issuance. The issuing company or group receives cash proceeds from the sale, which is then used to fund operations or expand the business.

The secondary market is where investors purchase securities or assets from other investors, rather than from issuing companies themselves. The Securities and Exchange Commission (SEC) registers securities prior to their primary issuance, then they start trading in the secondary market on the New York Stock Exchange, Nasdaq or other venue where the securities have been accepted for listing and trading.

The secondary market is where the bulk of exchange trading occurs each day. Primary markets can see increased volatility over secondary markets because it is difficult to accurately gauge investor demand for a new security until several days of trading have occurred. In the primary market, prices are often set beforehand, whereas in the secondary market only basic forces like supply and demand determine the price of the security.

Secondary markets exist for other securities as well, such as when funds, investment banks or entities such as Fannie Mae purchase mortgages from issuing lenders. In any secondary market trade, the cash proceeds go to an investor rather than to the underlying company/entity directly.

The-OTC-Market

The over-the-counter (OTC) market is a type of secondary market also referred to as a dealer market. The term "over-the-counter" refers to stocks that are not trading on a stock exchange such as the Nasdaq, NYSE or American Stock Exchange (AMEX). This generally means that the stock trades either on the over-the-counter bulletin board (OTCBB) or the pink sheets. Neither of these networks is an exchange; in fact, they describe themselves as providers of pricing information for securities. OTCBB and pink sheet companies have far fewer regulations to comply with than those that trade shares on a stock exchange. Most securities that trade this way are penny stocks or are from very small companies.

Third-and-Fourth-Markets

You might also hear the terms "third" and "fourth markets." These don't concern individual investors because they involve significant volumes of shares to be transacted per trade. These markets deal with transactions between broker-dealers and large institutions through over-the-counter electronic networks. The third market comprises OTC transactions between broker-dealers and large institutions. The fourth market is made up of transactions that take place between large institutions. The main reason these third and fourth market transactions occur is to avoid placing these orders through the main exchange, which could greatly affect the price of the security. Because access to the third and fourth markets is limited, their activities have little effect on the average investor.

Financial institutions and financial markets help firms raise money. They can do this by taking out a loan from a bank and repaying it with interest, issuing bonds to borrow money from investors that will be repaid at a fixed interest rate, or offering investors partial ownership in the company and a claim on its residual cash flows in the form of stock.

Introduction - Types Of Financial Institutions And Their Roles

A financial institution is an establishment that conducts financial transactions such as investments, loans and deposits. Almost everyone deals with financial institutions on a regular basis. Everything from depositing money to taking out loans and exchanging currencies must be done through financial institutions. Here is an overview of some of the major categories of financial institutions and their roles in the financial system.

Commercial-Banks

Commercial banks accept deposits and provide security and convenience to their customers. Part of the original purpose of banks was to offer customers safe keeping for their money. By keeping physical cash at home or in a wallet, there are risks of loss due to theft and accidents, not to mention the loss of possible income from interest. With banks, consumers no longer need to keep large amounts of currency on hand; transactions can be handled with checks, debit cards or credit cards, instead.

Commercial banks also make loans that individuals and businesses use to buy goods or expand business operations, which in turn leads to more deposited funds that make their way to banks. If banks can lend money at a higher interest rate than they have to pay for funds and operating costs, they make money.

Banks also serve often under-appreciated roles as payment agents within a country and between nations. Not only do banks issue debit cards that allow account holders to pay for goods with the swipe of a card, they can also arrange wire transfers with other institutions. Banks essentially underwrite financial transactions by lending their reputation and credibility to the transaction; a check is basically just a promissory note between two people, but without a bank's name and information on that note, no merchant would accept it. As payment agents, banks make commercial transactions much more convenient; it is not necessary to carry around large amounts of physical currency when merchants will accept the checks, debit cards or credit cards that banks provide.

Investment-Banks

The stock market crash of 1929 and ensuing Great Depression caused the United States government to increase financial market regulation. The Glass-Steagall Act of 1933 resulted in the separation of investment banking from commercial banking.

While investment banks may be called "banks," their operations are far different than deposit-gathering commercial banks. An investment bank is a financial intermediary that performs a variety of services for businesses and some governments. These services include underwriting debt and equity offerings, acting as an intermediary between an issuer of securities and the investing public, making markets, facilitating mergers and other corporate reorganizations, and acting as a broker for institutional clients. They may also provide research and financial advisory services to companies. As a general rule, investment banks focus on initial public offerings (IPOs) and large public and private share offerings. Traditionally, investment banks do not deal with the general public. However, some of the big names in investment banking, such as JP Morgan Chase, Bank of America and Citigroup, also operate commercial banks. Other past and present investment banks you may have heard of include Morgan Stanley, Goldman Sachs, Lehman Brothers and First Boston.

Generally speaking, investment banks are subject to less regulation than commercial banks. While investment banks operate under the supervision of regulatory bodies, like the Securities and Exchange Commission, FINRA, and the U.S. Treasury, there are typically fewer restrictions when it comes to maintaining capital ratios or introducing new products.

Insurance-Companies

Insurance companies pool risk by collecting premiums from a large group of people who want to protect themselves and/or their loved ones against a particular loss, such as a fire, car accident, illness, lawsuit, disability or death. Insurance helps individuals and companies manage risk and preserve wealth. By insuring a large number of people, insurance companies can operate profitably and at the same time pay for claims that may arise. Insurance companies use statistical analysis to project what their actual losses will be within a given class. They know that not all insured individuals will suffer losses at the same time or at all.

Brokerages

A brokerage acts as an intermediary between buyers and sellers to facilitate securities transactions. Brokerage companies are compensated via commission after the transaction has been successfully completed. For example, when a trade order for a stock is carried out, an individual often pays a transaction fee for the brokerage company's efforts to execute the trade.

A brokerage can be either full service or discount. A full service brokerage provides investment advice, portfolio management and trade execution. In exchange for this high level of service, customers pay significant commissions on each trade. Discount brokers allow investors to perform their own investment research and make their own decisions. The brokerage still executes the investor's trades, but since it doesn't provide the other services of a full-service brokerage, its trade commissions are much smaller.

Investment-Companies

An investment company is a corporation or a trust through which individuals invest in diversified, professionally managed portfolios of securities by pooling their funds with those of other investors. Rather than purchasing combinations of individual stocks and bonds for a portfolio, an investor can purchase securities indirectly through a package product like a mutual fund.

There are three fundamental types of investment companies: unit investment trusts (UITs), face amount certificate companies and managed investment companies. All three types have the following things in common:

- An undivided interest in the fund proportional to the number of shares held
- Diversification in a large number of securities
- Professional management
- Specific investment objectives

Let's take a closer look at each type of investment company.

Unit-Investment-Trusts-(UITs)

A unit investment trust, or UIT, is a company established under an indenture or similar agreement. It has the following characteristics:

- The management of the trust is supervised by a trustee.
- Unit investment trusts sell a fixed number of shares to unit holders, who receive a proportionate share of net income from the underlying trust.

- The UIT security is redeemable and represents an undivided interest in a specific portfolio of securities.
- The portfolio is merely supervised, not managed, as it remains fixed for the life of the trust. In other words, there is no day-to-day management of the portfolio.

Face-Amount-Certificates

A face amount certificate company issues debt certificates at a predetermined rate of interest. Additional characteristics include:

- Certificate holders may redeem their certificates for a fixed amount on a specified date, or for a specific surrender value, before maturity.
- Certificates can be purchased either in periodic installments or all at once with a lump-sum payment.
- Face amount certificate companies are almost nonexistent today.

Management-Investment-Companies

The most common type of investment company is the management investment company, which actively manages a portfolio of securities to achieve its investment objective. There are two types of management investment company: closed-end and open-end. The primary differences between the two come down to where investors buy and sell their shares - in the primary or secondary markets - and the type of securities the investment company sells.

- *Closed-End Investment Companies*: A closed-end investment company issues shares in a one-time public offering. It does not continually offer new shares, nor does it redeem its shares like an open-end investment company. Once shares are issued, an investor may purchase them on the open market and sell them in the same way. The market value of the closed-end fund's shares will be based on supply and demand, much like other securities. Instead of selling at net asset value, the shares can sell at a premium or at a discount to the net asset value.

- *Open-End Investment Companies*: Open-end investment companies, also known as mutual funds, continuously issue new shares. These shares may only be purchased from the investment company and sold back to the investment company. Mutual funds are discussed in more detail in the Variable Contracts section.

Nonbank-Financial-Institutions

The following institutions are not technically banks but provide some of the same services as banks.

Savings-and-Loans

Savings and loan associations, also known as S&Ls or thrifts, resemble banks in many respects. Most consumers don't know the differences between commercial banks and S&Ls. By law, savings and loan companies must have 65% or more of their lending in residential mortgages, though other types of lending is allowed.

S&Ls emerged largely in response to the exclusivity of commercial banks. There was a time when banks would only accept deposits from people of relatively high wealth, with references, and would not lend to ordinary workers. Savings and loans typically offered lower borrowing rates than commercial banks and higher interest rates on deposits; the narrower profit margin was a byproduct of the fact that such S&Ls were privately or mutually owned.

Credit-Unions

Credit unions are another alternative to regular commercial banks. Credit unions are almost always organized as not-for-profit cooperatives. Like banks and S&Ls, credit unions can be chartered at the federal or state level. Like S&Ls, credit unions typically offer higher rates on deposits and charge lower rates on loans in comparison to commercial banks.

In exchange for a little added freedom, there is one particular restriction on credit unions; membership is not open to the public, but rather restricted to a particular membership group. In the past, this has meant that employees of certain companies, members of certain churches, and so on, were the only ones allowed to join a credit union. In recent years, though, these restrictions have been eased considerably, very much over the objections of banks.

Shadow-Banks

The housing bubble and subsequent credit crisis brought attention to what is commonly called "the shadow banking system." This is a collection of investment banks, hedge funds, insurers and other non-bank financial institutions that replicate some of the activities of regulated banks, but do not operate in the same regulatory environment.

The shadow banking system funneled a great deal of money into the U.S. residential mortgage market during the bubble. Insurance companies would buy mortgage bonds from investment banks, which would then use the proceeds to buy more mortgages, so that they could issue more mortgage bonds. The banks would use the money obtained from selling mortgages to write still more mortgages.

Many estimates of the size of the shadow banking system suggest that it had grown to match the size of the traditional U.S. banking system by 2008.

Apart from the absence of regulation and reporting requirements, the nature of the operations within the shadow banking system created several problems. Specifically, many of these institutions "borrowed short" to "lend long." In other words, they financed long-term commitments with short-term debt. This left these institutions very vulnerable to increases in short-term rates and when those rates rose, it forced many institutions to rush to liquidate investments and make margin calls. Moreover, as these institutions were not part of the formal banking system, they did not have access to the same emergency funding facilities.