

INTRODUCTION TO FINANCIAL MARKETS AND FINANCIAL INSTITUTIONS (560-1)

[The financial industry operated as a full-service industry until regulatory changes in the 1930s separated activities, erecting boundaries among different types of financial institutions.

Those boundaries among different types of financial institutions have now been largely removed as a result of

1. *regulatory changes,*
2. *technological advances, and*
3. *financial innovations*

which have combined to once again allow individual financial institutions to offer all financial services.]

EO 1. **TYPES OF FINANCIAL MARKETS:** Financial markets are structures through which funds flow. **Financial markets are categorized in two ways:**

1. **Primary versus secondary markets:**

a. **The primary market**--trades newly issued securities.

A corporation can raise money by selling newly-issued stocks to households and other investors through the primary market.

Investment banks arrange primary market transactions by buying a corporation's entire new issue at a set price and then selling that new issue to investors at a slightly higher price. A corporation's first public issue of financial instruments is called its **initial public offering (IPO)**.

b. **The secondary market**--trades previously issued securities.

The original issuer of the security is *not* involved in the trade.

Securities brokers arrange secondary market transactions.

Secondary markets trade in stocks, bonds, financial instruments backed by mortgages and other assets, foreign exchange, *and* **derivative securities (aka derivatives)** (securities whose payoffs are linked to other previously issued securities).

Secondary markets benefit both buyers and sellers through both

- 1) **liquidity** (Securities can be converted to cash quickly, at low transaction costs.) *and*
- 2) **diversification** (Holding a number of different securities reduces the risk of loss.)

Secondary markets benefit original issuing corporations by providing information on the current value of its previously-issued securities, which in turn reflects the corporation's current value *and* influencing the likely selling price of any new issue.

2. **Money markets versus capital markets:**

a. **The money market**--trades **money market instruments**, which are debt securities (instruments) with maturities of less than one year.

Price fluctuations in the money market are small.

US money markets are called **over-the-counter (OTC) markets** because they do *not* operate in a specific location but *do* operate (trade) via telephone, wire transfer, and computer.

b. **The capital market**--trades **capital market instruments**, which are debt (bonds) and equity (stocks) instruments with maturities of more than one year (or no maturity at all).

Price fluctuations are larger than with money market instruments.

[The Securities and Exchange Commission (SEC) regulates financial markets by

1. *emphasizing full and fair disclosure of information and*
2. *monitoring markets for evidence of insider trading.]*

*[Recent SEC **circuit breaker regulations** reduce price fluctuations by shutting down markets when prices drop by large amounts.]*

[Foreign exchange markets are financial markets in other countries, denominated in currencies other than US dollars.

US investors who buy securities through a foreign exchange market risk the depreciation of that foreign currency relative to the dollar.

If the foreign currency depreciates (or the dollar appreciates), the dollar value of cash flows (interest, dividends, and return of principal) from that foreign investment will decrease, and, of course, vice versa.]

EO 2. THE ROLES OF FINANCIAL INSTITUTIONS (FIs) IN FINANCIAL MARKETS:

Financial institutions (FIs) channel funds from those with surplus funds to those that need funds.

[See Table 1-2 for a list of types of financial institutions.]

Hence, financial institutions allow indirect transfer of funds, in which buyers and sellers deal with an intermediary instead of with each other.

Without financial institutions, buyer and sellers would engage in direct transfer of funds, in which corporations sell

1. equities (common and preferred stocks) *and/or*
2. debt (commercial paper and bonds)

directly to investors.

The three main discouragements to direct investment:

1. monitoring costs--Investors must monitor, constantly, the use of their funds.
2. liquidity costs--Investors lose liquidity upon investment, especially in long-term projects.
3. price risk--Investors take the risk that an asset's sale price will be lower than its purchase price.

THROUGH INDIRECT TRANSFER, FINANCIAL INSTITUTIONS

1. **reduce monitoring costs**--Financial institutions, as delegated monitors, monitor the use of all their investors' funds by the ultimate users of those funds for *far* less money than it would take all investors to monitor their own investments separately.
2. **transform assets**--By buying corporations' securities and issuing them as secondary securities that can be bought and sold quickly, financial institutions increase the liquidity and decrease the price risk of those assets, making them more attractive to investors.
Financial institutions reduce their own investment risks, and pass those reductions along to investors, through diversification (buying different assets and different asset types).
3. **reduce transaction costs**--Financial institutions conduct transactions more efficiently than individual investors by using economies of scale (cost reductions from increased efficiency).
4. **act as maturity intermediaries**--Financial institutions can purposely mismatch maturities to offer both buyers and sellers the maturities they want.
A typical mismatch has the financial institution funding a long-term mortgage loan with funds from short-term savings and checking deposits.
The FI essentially assumes the interest rate risk that small investors can't handle.
5. **act as denomination intermediaries**--Financial institutions can buy assets sold in very large denominations and sell shares of those assets to small investors who otherwise wouldn't be able to afford the minimum investment.
Example: A financial institution can buy a negotiable CD at the minimum size of \$100,000 and then sell shares of the CD to small investors through a mutual fund.
6. **transmit monetary policy**--The size of the money supply (the measure of the money stock in a nation) is determined largely by bank and/or thrift deposits.

The Federal Reserve uses its control over depository institutions to

- a. control the money supply **and thus**
- b. control the rate of inflation.

7. **allocate credit**--Financial institutions can extend credit to those sectors of the economy in need of financing.
Policymakers decide which sectors need financing and then encourage financial institutions to extend credit.
8. **act as time intermediaries**--Pension and life insurance funds let savers transfer wealth from their youth to their old age, or from one generation to the next.
9. **provide payment services**--Depository institutions provide check clearing and wire transfer services to speed up the payment process among buyers and sellers.

EO 3. **TEN RISKS FACED BY FINANCIAL INSTITUTIONS:**

1. **Credit risk**--is the risk that promised cash flows from loans and securities held by financial institutions will *not* be paid in full.
2. **Foreign exchange risk**--is the risk that fluctuating exchange rates will adversely affect the values of assets and liabilities located abroad if the dollar depreciates or the foreign currency appreciates.
3. **Country or sovereign risk**--is the risk that repayments from foreign borrowers will be interrupted due to interference from foreign governments.
4. **Interest rate risk**--occurs when the maturities of the financial institution's assets and liabilities are mismatched.
5. **Market risk**--is the risk that changes in interest rates, exchange rates, and other prices will result in trading losses.
6. **Off-balance-sheet risk**--is the risk that the financial institution will lose money due to activities related to contingent assets and liabilities.
7. **Liquidity risk**--is the risk that a surge in liability withdrawals will force the financial institution to liquidate assets at low prices.
8. **Technology risk**--is the risk that technological investments won't produce the expected savings.
9. **Operational risk**--is the risk that existing technology or support systems will break down.
10. **Insolvency risk**--is the risk that the financial institution won't have enough capital to offset a sudden decline in the value of its assets.

EO 4. **FIVE FACTORS HAVE CAUSED THE GLOBALIZATION OF FINANCIAL MARKETS:**

1. **The increased pool of savings in foreign countries**--Foreign countries have more money to invest in other countries.
2. **The growth of international investors**--International investors have been very interested in buying into US and private pension plans as the value of public pension plans in Europe has declined.
3. **More, and faster, information**--The Internet and other technological advances have made international investment easier to research and therefore safer.
4. **Financial institution encouragement of foreign investment**--Some US financial institutions offer foreign securities at low transaction costs.
US investors can buy foreign securities almost as easily as they buy domestic securities.
5. **Deregulation**--Deregulation in many foreign countries has encouraged international investment.

[Eurodollar bonds are dollar-denominated bonds issued in Europe.

*Eurodollar bonds are **not** regulated by the SEC.*

Eurodollar bonds account for over 80% of new issues in the international bond market.]