



Financial market institutions

1. Introduction



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Outline:

- Why Study Financial Markets and Institutions?
- Function of Financial Market
- Structure of Financial Market
- Types of financial markets
- Securities traded in financial markets
- Global financial markets



Why Study Financial Markets?

Financial markets, such as bond and stock markets, are crucial in our economy.

1. These markets channel funds from savers to investors, thereby promoting economic efficiency.
2. Market activity affects personal wealth, the behavior of business firms, and economy as a whole



Why Study Financial Markets?

- Well functioning financial markets, such as the bond market, stock market, and foreign exchange market, are key factors in producing high economic growth.
- We will briefly examine each of these markets, key statistics, and how we will study them throughout this course.



Why Study Financial Markets?

Debt Markets & Interest Rates

- Debt markets, or bond markets, allow governments, corporations, and individuals to borrow to finance activities.
- In this market, borrowers issue a security, called a bond, that promises the timely payment of interest and principal over some specific time horizon.
- The interest rate is the cost of borrowing.



Why Study Financial Markets?

The Stock Market

- The stock market is the market where common stock (or just stock), representing ownership in a company, are traded.
- Companies initially sell stock (in the primary market) to raise money. But after that, the stock is traded among investors (secondary market).
- Of all the active markets, the stock market receives the most attention from the media. Why?

Dow Jones
Industrial Average

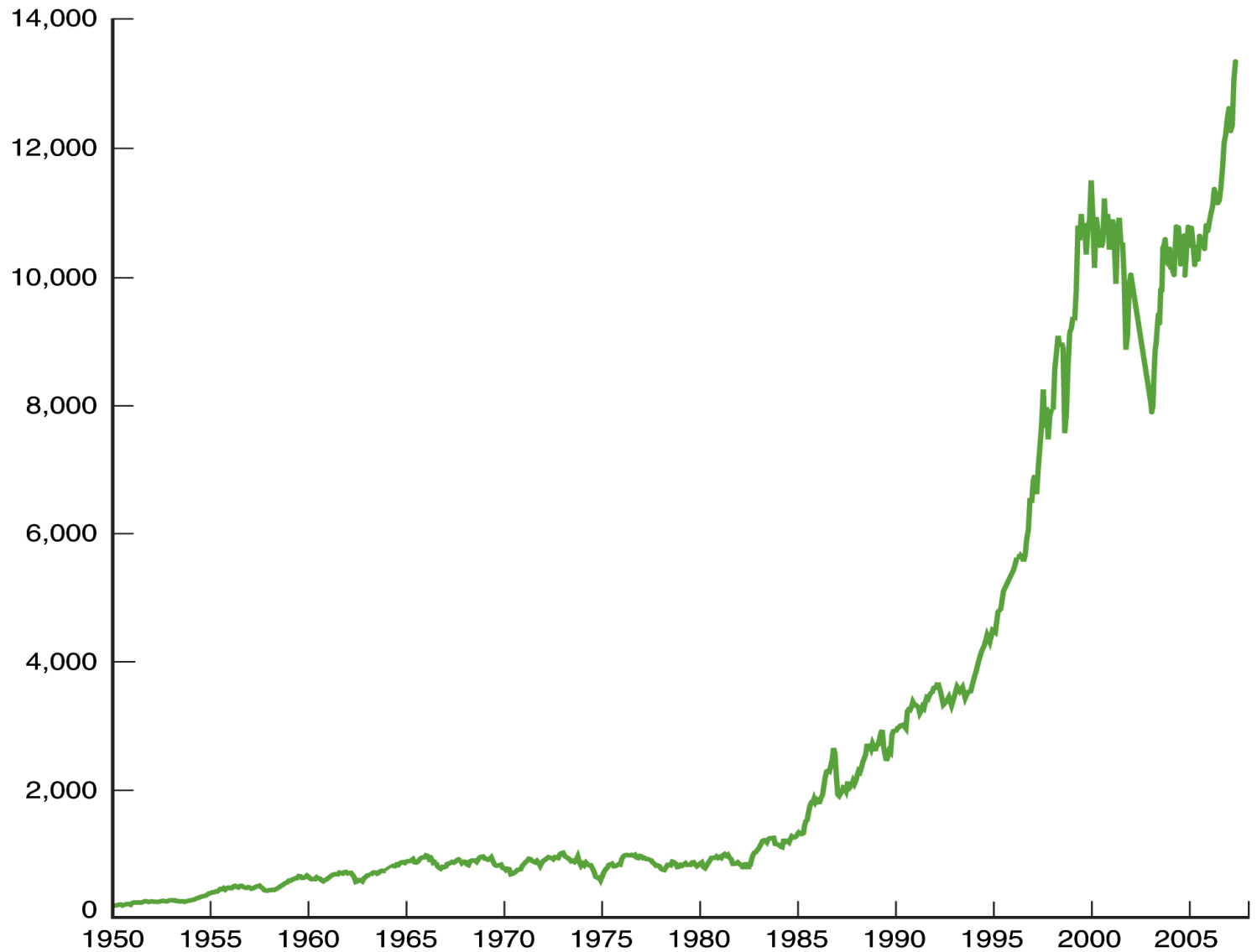


Figure 1.2 Stock Prices as Measured by the Dow Jones Industrial Average, 1950–2007

Source: Dow Jones Indexes: <http://finance.yahoo.com/?u>.



Why Study Financial Markets? The Foreign Exchange Market

- The foreign exchange market is where international currencies trade and exchange rates are set.
- Although most people know little about this market, it has a *daily* volume around \$1 trillion!



Why Study Financial Institutions?

We will also spend considerable time discussing financial institutions—the corporations, organizations, and networks that operate the so-called “marketplaces.” **(The Financial System)**

1. Why Financial Markets are structured the way they are?
 - Helps get funds from savers to investors
2. The Role of Banks and Other Financial Institutions
 - Includes the role of insurance companies, mutual funds, pension funds, etc.



Why Study Financial Institutions?

3. Financial Innovation

- Focusing on the improvements in technology and its impact on how financial products are delivered

4. Managing Risk in Financial Institutions

- Focusing on risk management in the financial institution.



Function of Financial Markets

- A **Financial Market** is a market in which financial assets (securities) can be purchased or sold.
- Financial markets facilitate transfers of funds from person or business without investment opportunities (i.e., “Lender-Savers”, or “Surplus Unit”) to those who have investment opportunities (i.e., “Borrower-Spenders”, or “Deficit Unit”).



Segments of Financial Markets

- **Direct Financing**

- Funds are transferred directly from ultimate savers to ultimate borrowers

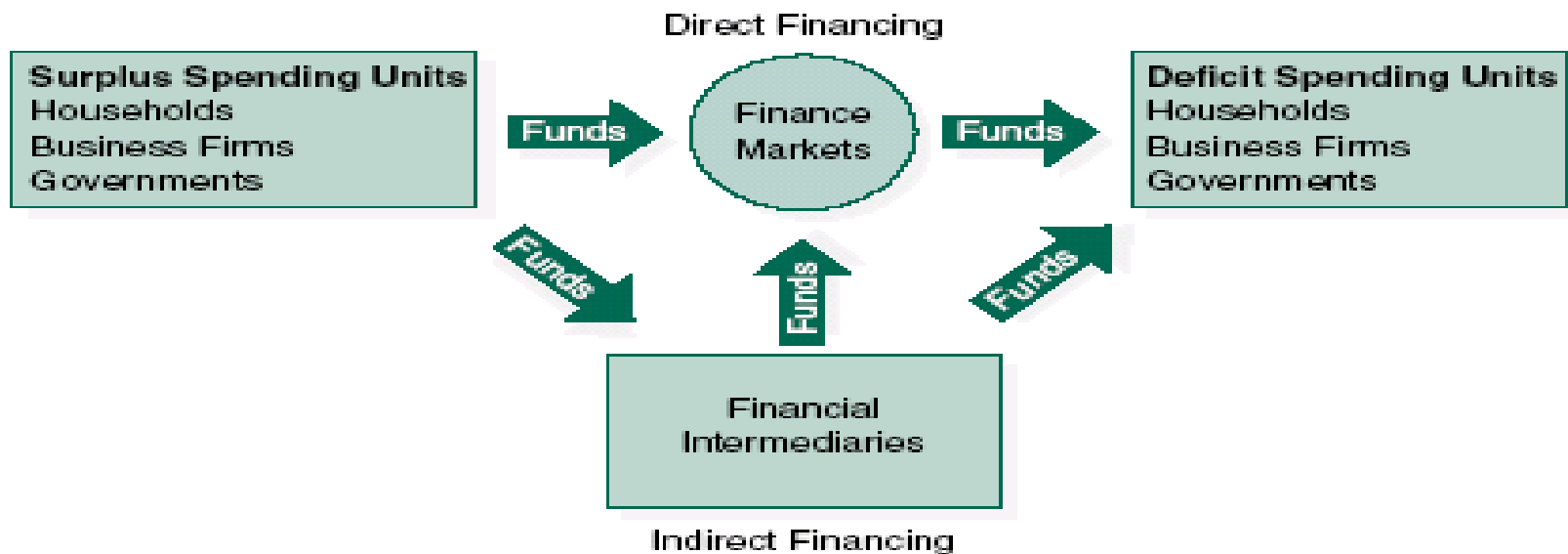
- **Indirect Financing**

- A financial "intermediary" transforms financial claims with one set of characteristics into financial claims with other characteristics e.g. deposits are used to make loans.

Transfer of Funds on Financial Market

EXHIBIT 1.1

Transfer of Funds from Surplus to Deficit Spending Units



The role of the financial system—financial institutions and markets—is to facilitate the flow and efficient allocation of funds throughout the economy. The greater the flow of funds, the greater the accommodation of individuals' preferences for spending and saving. An efficient and sound financial system is a necessary condition to having a highly advanced economy like the one in the United States.



Function of Financial Intermediaries

- Provide customers with liquidity service
- Help to repackage the risk
 - Willing to create and sell assets with lesser risk to one party in order to buy assets with greater risk from another party
 - This process is referred to as **asset transformation**



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**



Types of Financial 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



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 Money Markets

- Treasury Bills.
- Certificate of Deposit (CDs).
- Commercial Papers.
- Eurodollar Deposits.
- Banker's Acceptance.
- Federal Funds.
- Repurchase Agreements.



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 Capital Markets

- Treasury Notes and Bonds.
- Municipal Bonds.
- Corporate Bonds.
- Mortgages.
- Commons Stocks.
- Preferred Stocks.



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



Valuation of Securities in Financial Markets

- The valuation of a security is measured as the present value of its expected cash flows, discounted at a rate that reflects the uncertainty of the cash flows (Risk).



Valuation of Securities in Financial Markets

- Impact of Information on Valuation.
- Impact of Valuation on Pricing.
- Impact of the internet on the Valuation Process.



Market Efficiency

- When security prices fully reflect all available information, the markets for those securities are said to be efficient.
- When Markets are inefficient, investors can use available information ignored by the market to earn abnormally high returns on their investments.



Market Efficiency

- **Impact of Asymmetric Information:**
- A firm's managers possess information about its financial condition that is not available to investors.
- This situation is referred to as asymmetric information.
- An Asymmetric information problem may still exist if some of the information provided by the firm's managers cannot be trusted.



Financial Market Regulations

- Financial Markets are regulated to ensure that the participants are treated fairly.
- Many regulations were enacted in response to fraudulent practices.
- **What is Disclosure?**



Global Financial Markets

- Global Integration.
- Barriers to Global Integration.
- Financial Markets Integration within Europe.
- Role of the Foreign Exchange Market.



Role of Financial Institutions in Financial Markets

- **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 Nondepository Financial Institutions:**
 - Nondepository institutions generate funds from sources other than deposits
 - Finance companies
 - Obtain funds by issuing securities
 - Lend funds to individuals and small businesses



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

- **Mutual Funds:**
 - 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:**

- **Broker** function

- Execute securities transactions between two parties
 - Charge a fee in the form of a **bid-ask spread**

- Investment banking function

- **Underwrite** newly issued securities

- **Dealer** function

- Securities firms make a market in specific securities by adjusting their inventory



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

- **Insurance Companies:**
 - Provide insurance policies to individuals and firms for death, illness, and damage to property
 - Charge premiums
 - Invest in stocks or bonds issued by corporations

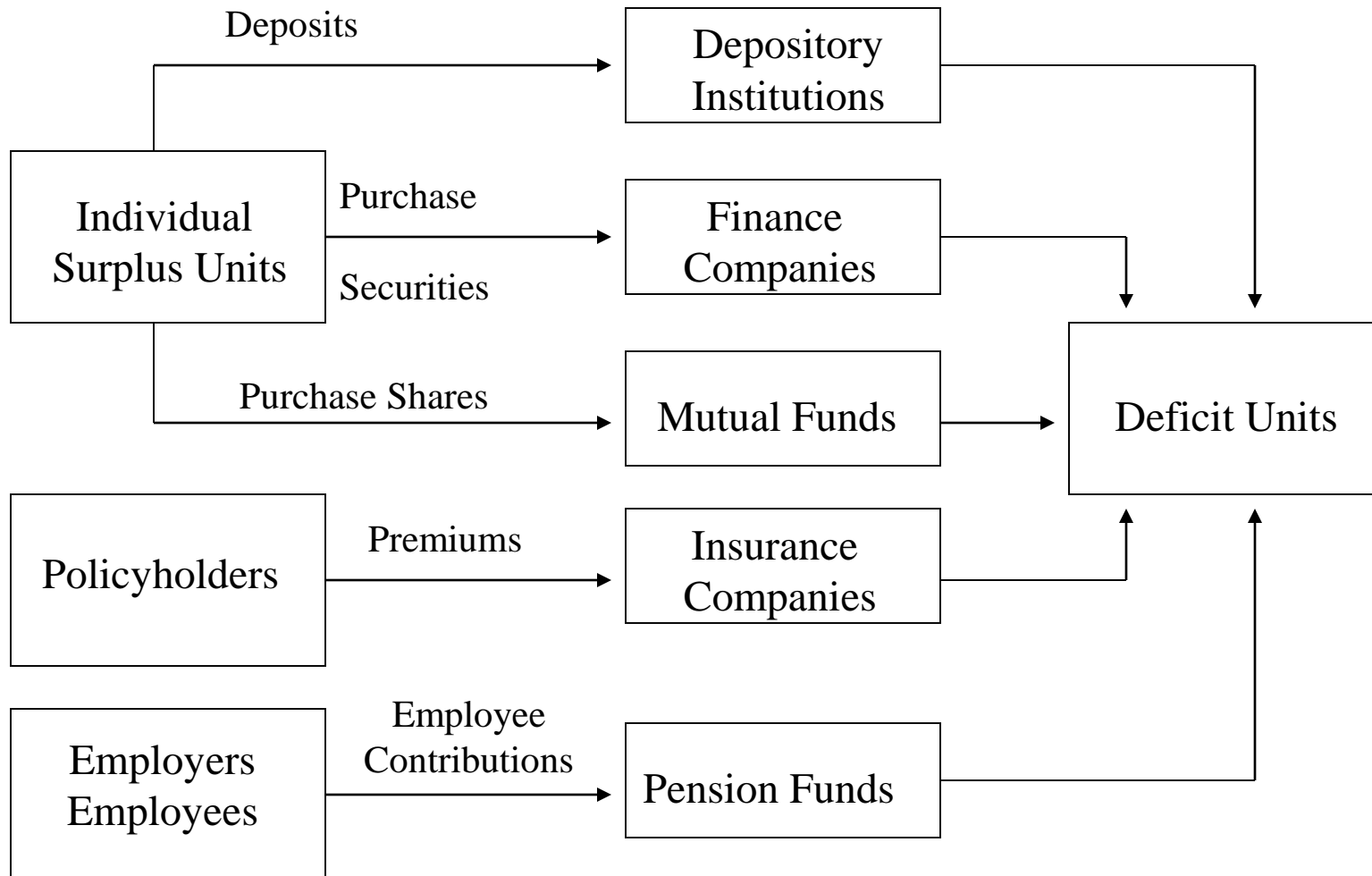


Role of Financial Institutions in Financial Markets (cont'd)

- **Pension Funds:**
 - 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)

- **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



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Thanks