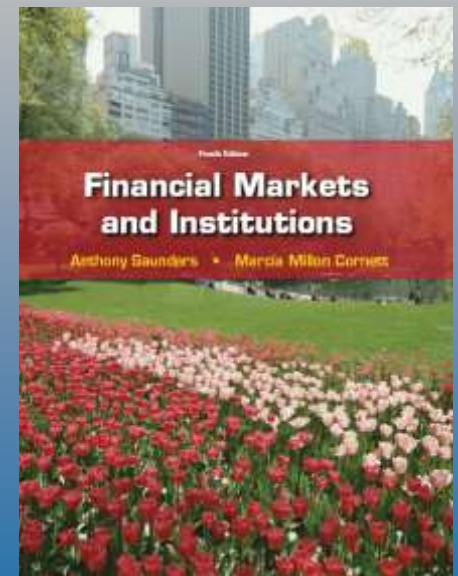


Chapter One

Introduction



Why study Financial Markets and Institutions?

- **Prudent investment and financing requires a thorough understanding of**
 - the structure of domestic and international markets
 - the flow of funds through domestic and international markets
 - the strategies used to manage risks faced by investors and savers

Financial Markets

- **Financial markets are structures through which funds flow**
- **Financial markets can be distinguished along two dimensions**
 - primary versus secondary markets
 - money versus capital markets

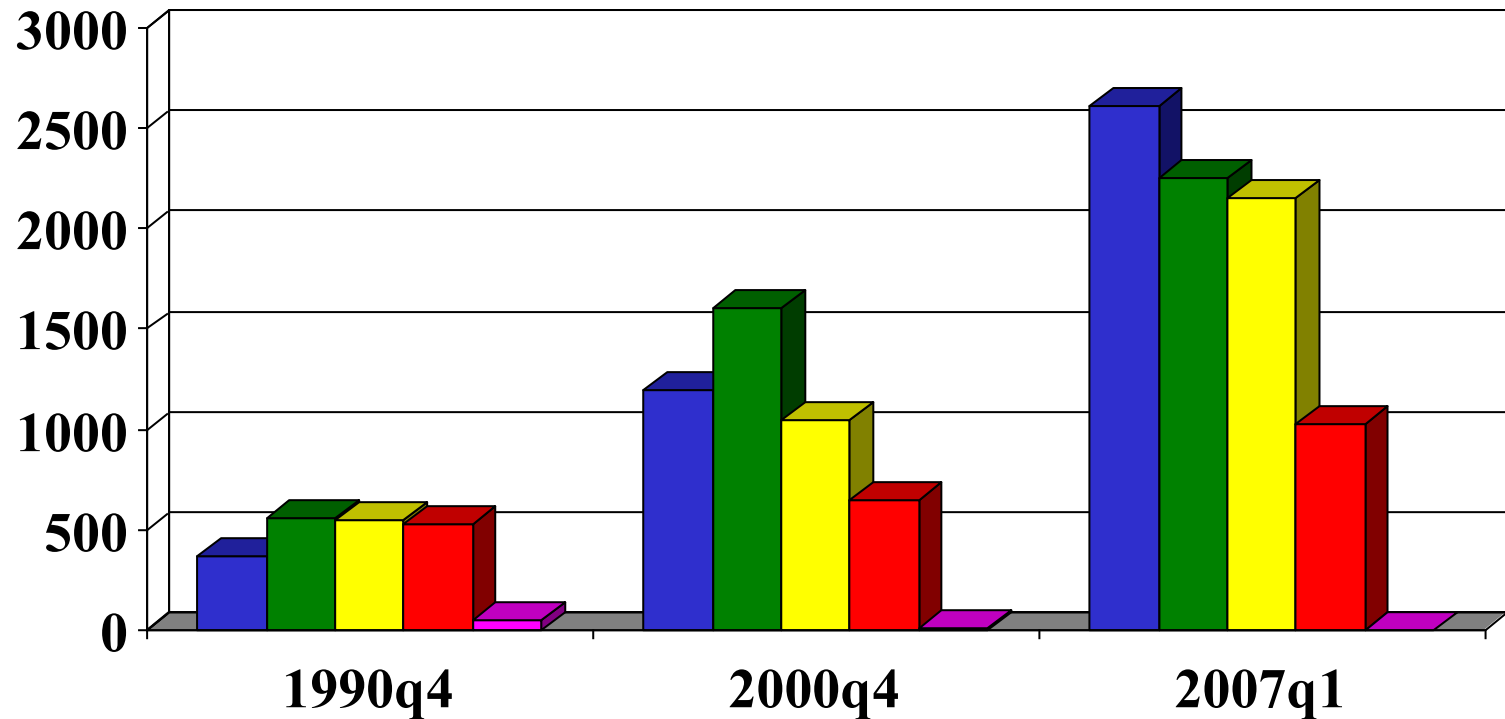
Primary versus Secondary Markets

- **Primary markets**
 - markets in which users of funds (e.g., corporations and governments) raise funds by issuing financial instruments (e.g., stocks and bonds)
- **Secondary markets**
 - markets where financial instruments are traded among investors (e.g., NYSE and Nasdaq)

Money versus Capital Markets

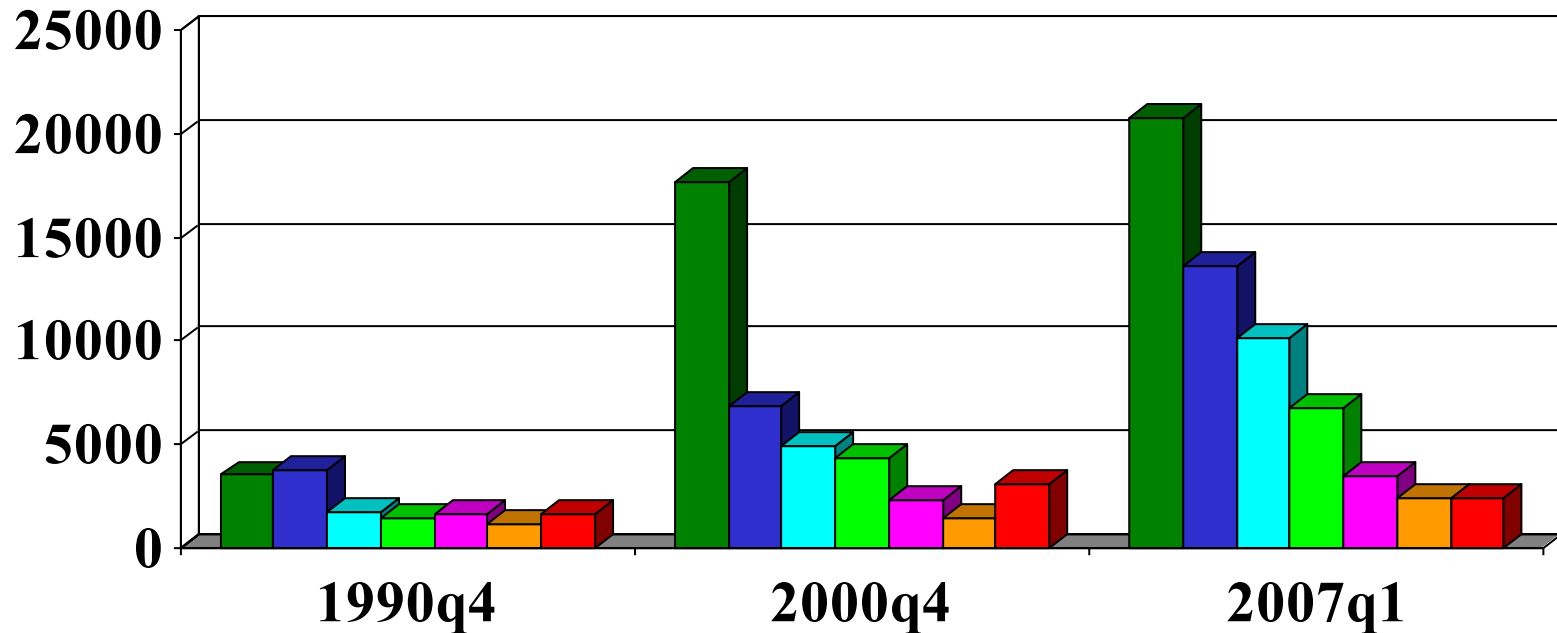
- **Money markets**
 - markets that trade debt securities with maturities of one year or less (e.g., CDs and U.S. Treasury bills)
- **Capital markets**
 - markets that trade debt (bonds) and equity (stock) instruments with maturities of more than one year

Money Market Instruments Outstanding, (\$Bn)



■ Fed funds and repos ■ Commercial paper ■ Negotiable CDs
■ U.S. Treasury bills ■ Banker's accept.

Capital Market Instruments Outstanding, (\$Bn)



■ Corporate stocks

■ Mortgages

■ Corporate bonds

■ U.S. gov't agencies

■ Treasury securities

■ State & local gov't bonds

■ Bank and consumer loans

Foreign Exchange (FX) Markets

- **FX markets**
 - trading one currency for another (e.g., dollar for yen)
- **Spot FX**
 - the immediate exchange of currencies at current exchange rates
- **Forward FX**
 - the exchange of currencies in the future on a specific date and at a pre-specified exchange rate

Derivative Security Markets

- **Derivative security**

- a financial security whose payoff is linked to (i.e., “derived” from) another security or commodity
- generally an agreement to exchange a standard quantity of assets at a set price on a specific date in the future

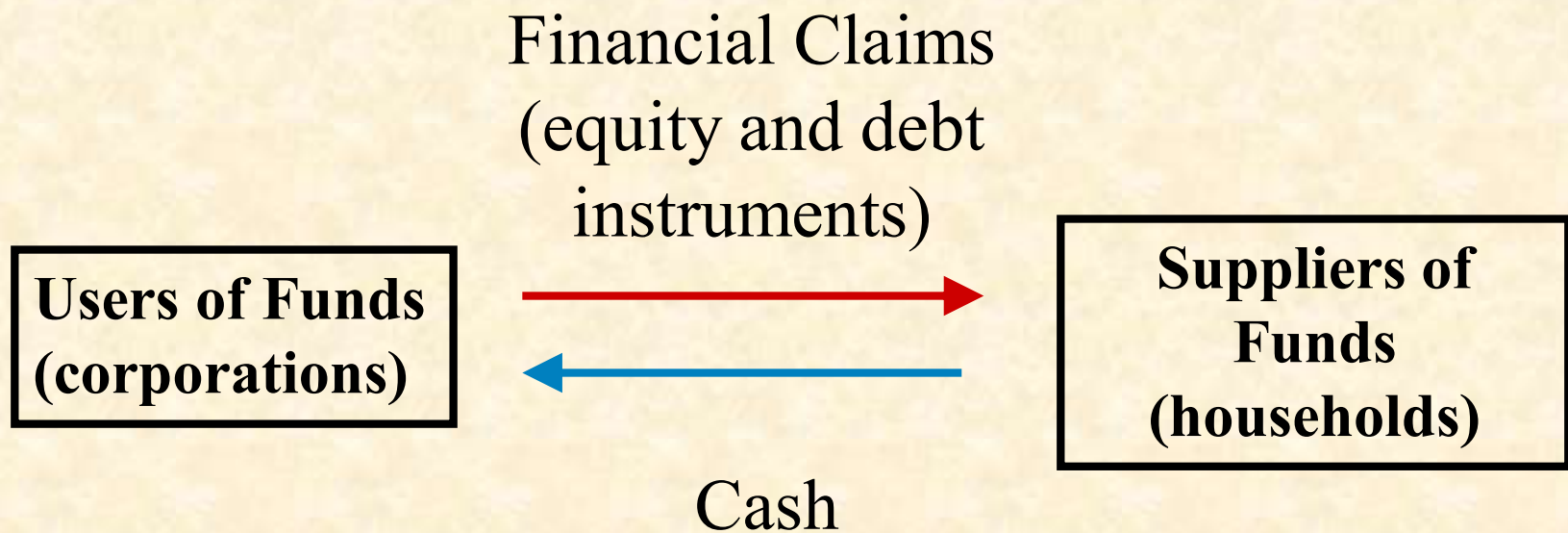
Financial Market Regulation

- **The Securities Act of 1933**
 - full and fair disclosure and securities registration
- **The Securities Exchange Act of 1934**
 - Securities and Exchange Commission (SEC) is the main regulator of securities markets

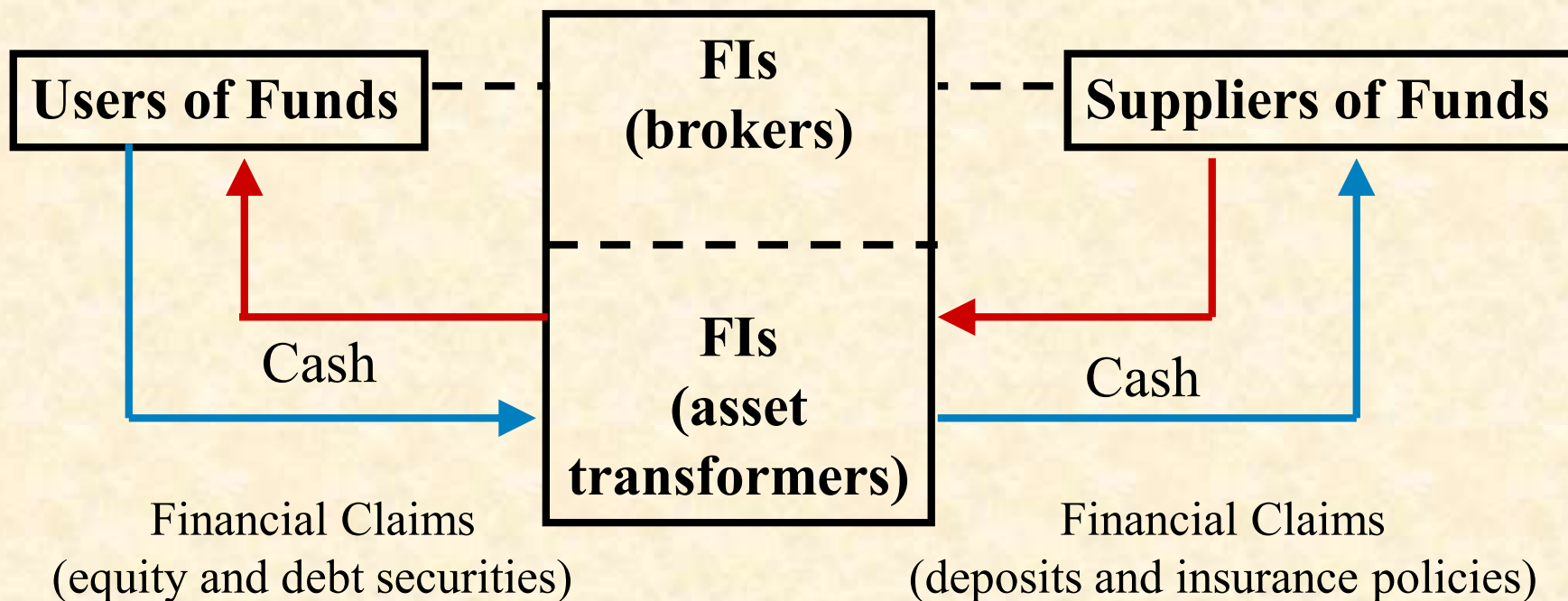
Financial Institutions (FIs)

- **Financial Institutions**
 - institutions through which suppliers channel money to users of funds
- **Financial Institutions are distinguished by whether they accept deposits**
 - depository versus non-depository financial institutions

Flow of Funds in a World without FIs



Flow of Funds in a World with FIs



Depository versus Non-Depository FIs

- **Depository institutions**
 - commercial banks, savings associations, savings banks, credit unions
- **Non-depository institutions**
 - insurance companies, securities firms and investment banks, mutual funds, pension funds

FIs Benefit Suppliers of Funds

- **Reduce monitoring costs**
- **Increase liquidity and lower price risk**
- **Reduce transaction costs**
- **Provide maturity intermediation**
- **Provide denomination intermediation**

FIs Benefit the Overall Economy

- **Conduit through which Federal Reserve conducts monetary policy**
- **Provides efficient credit allocation**
- **Provide for intergenerational wealth transfers**
- **Provide payment services**

Risks Faced by Financial Institutions

- **Credit**
- **Foreign exchange**
- **Country or sovereign**
- **Interest rate**
- **Market**

- **Off-balance-sheet**
- **Liquidity**
- **Technology**
- **Operational**
- **Insolvency**

Regulation of Financial Institutions

- **FIs are heavily regulated to protect society at large from market failures**
- **Regulations impose a burden on FIs and recent U.S. regulatory changes have been deregulatory in nature**
- **Regulators attempt to maximize social welfare while minimizing the burden imposed by regulation**

Globalization of Financial Markets and Institutions

- **The pool of savings from foreign investors is increasing and investors look to diversify globally now more than ever before**
- **Information on foreign markets and investments is becoming readily accessible and deregulation across the globe is allowing even greater access**
- **International mutual funds allow diversified foreign investment with low transactions costs**