

# CHAPTER 2

## An Overview of the Financial System

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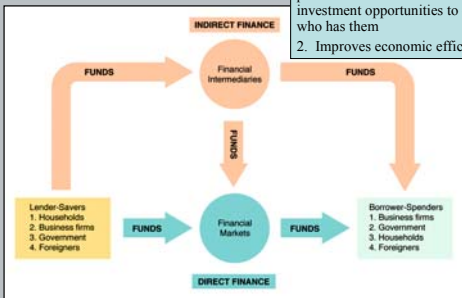
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## Function of Financial Markets

1. Allows transfers of funds from person or business without investment opportunities to one who has them
2. Improves economic efficiency



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## Classifications of Financial Markets

- 1. Debt Markets**
  - Short-term (maturity < 1 year) Money Market
  - Long-term (maturity > 1 year) Capital Market
- 2. Equity Markets**
  - Common stocks
- 1. Primary Market**
  - New security issues sold to initial buyers
- 2. Secondary Market**
  - Securities previously issued are bought and sold
- 1. Exchanges**
  - Trades conducted in central locations (e.g., New York Stock Exchange)
- 2. Over-the-Counter Markets**
  - Dealers at different locations buy and sell

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## Internationalization of Financial Markets

### International Bond Market

1. Foreign bonds
2. Eurobonds

Now larger than U.S. corporate bond market

### World Stock Markets

U.S. stock markets are no longer always the largest: Japan sometimes larger

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## Function of Financial Intermediaries

### Financial Intermediaries

1. Engage in process of indirect finance
2. More important source of finance than securities markets
3. Needed because of transactions costs and asymmetric information

### Transactions Costs

1. Financial intermediaries make profits by reducing transactions costs
2. Reduce transactions costs by developing expertise and taking advantage of economies of scale

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## Function of Financial Intermediaries

### Risk Sharing

1. Create and sell assets with low risk characteristics and then use the funds to buy assets with more risk (also called **asset transformation**).
2. Also lower risk by helping people to diversify portfolios

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## Asymmetric Information: Adverse Selection, and Moral Hazard

### Adverse Selection

1. Before transaction occurs
2. Potential borrowers most likely to produce adverse outcomes are ones most likely to seek loans and be selected

### Moral Hazard

1. After transaction occurs
2. Hazard that borrower has incentives to engage in undesirable (immoral) activities making it more likely that won't pay loan back

**Financial intermediaries reduce adverse selection and moral hazard problems, enabling them to make profits**

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## Financial Intermediaries

**Table 1 Primary Assets and Liabilities of Financial Intermediaries**

Type of Intermediary	Primary Liabilities (Sources of Funds)	Primary Assets (Uses of Funds)
<b>Depository institutions (banks)</b>		
Commercial banks	Deposits	Business and consumer loans, mortgages, U.S. government securities and municipal bonds
Savings and loan associations	Deposits	Mortgages
Mutual savings banks	Deposits	Mortgages
Credit unions	Deposits	Consumer loans
<b>Contractual savings institutions</b>		
Life insurance companies	Premiums from policies	Corporate bonds and mortgages
Fire and casualty insurance companies	Premiums from policies	Municipal bonds, corporate bonds and stock, U.S. government securities
Pension funds, government retirement funds	Employer and employer contributions	Corporate bonds and stock
<b>Investment intermediaries</b>		
Finance companies	Commercial paper, stocks, bonds	Consumer and business loans
Mutual funds	Shares	Stocks, bonds
Money market mutual funds	Shares	Money market instruments

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## Size of Financial Intermediaries

**Table 2 Principal Financial Intermediaries and Value of Their Assets**

Type of Intermediary	Value of Assets (\$ billions, end of year)			
	1970	1980	1990	2002
<b>Depository institutions (banks)</b>				
Commercial banks	517	1,481	3,334	7,161
Savings and loan associations and mutual savings banks	250	792	1,365	1,338
Credit unions	18	67	215	553
<b>Contractual savings institutions</b>				
Life insurance companies	201	464	1,367	3,269
Fire and casualty insurance companies	50	182	533	894
Pension funds (private)	112	504	1,629	3,531
State and local government retirement funds	60	197	737	1,895
<b>Investment intermediaries</b>				
Finance companies	64	205	610	1,165
Mutual funds	47	70	654	3,419
Money market mutual funds	0	76	498	2,106

Source: Federal Reserve Flow of Funds Accounts. [www.federalreserve.gov/releases/Z11/level/tables](http://www.federalreserve.gov/releases/Z11/level/tables).

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## Regulatory Agencies

**Table 3** 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	Charters and examines the books of federally chartered commercial banks and 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
State banking and insurance commissions	State-chartered depository institutions	Charters and examines the books of state-chartered banks and insurance companies, imposes restrictions on assets they can hold, and imposes restrictions on branching

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## Regulatory Agencies

**Table 3** Principal Regulatory Agencies of the U.S. Financial System

Regulatory Agency	Subject of Regulation	Nature of Regulations
Federal Deposit Insurance Corporation (FDIC)	Commercial banks, mutual savings banks, savings and loan associations	Provides insurance of up to \$100,000 for each depositor at a bank, examines the books of insured banks, and imposes restrictions on assets they can hold
Federal Reserve System	All depository institutions	Examines the books of commercial banks that are members of the system, sets reserve requirements for all banks
Office of Thrift Supervision	Savings and loan associations	Examines the books of savings and loan associations, imposes restrictions on assets they can hold
State banking and insurance commissions	State-chartered depository institutions	Charters and examines the books of state-chartered banks and insurance companies, imposes restrictions on assets they can hold, and imposes restrictions on branching

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## Regulation of Financial Markets

### Two Main Reasons for Regulation

#### 1. Increase information to investors

- A. Decreases adverse selection and moral hazard problems
- B. SEC forces corporations to disclose information

#### 2. Ensuring the soundness of financial intermediaries

- A. Prevents financial panics
- B. Chartering, reporting requirements, restrictions on assets and activities, deposit insurance, and anti-competitive measures

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