E216 : Economics of MONEY AND BANKING

Second grade

First term

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Chapter 2

An Overview of the Financial System

Chapter 2 outline

1. Meaning of Financial System
2. Function of financial Markets
3. Structure of Financial Markets
4. Instruments of Financial Markets
5. Types of financial intermediaries

1. Why Study Financial Markets?

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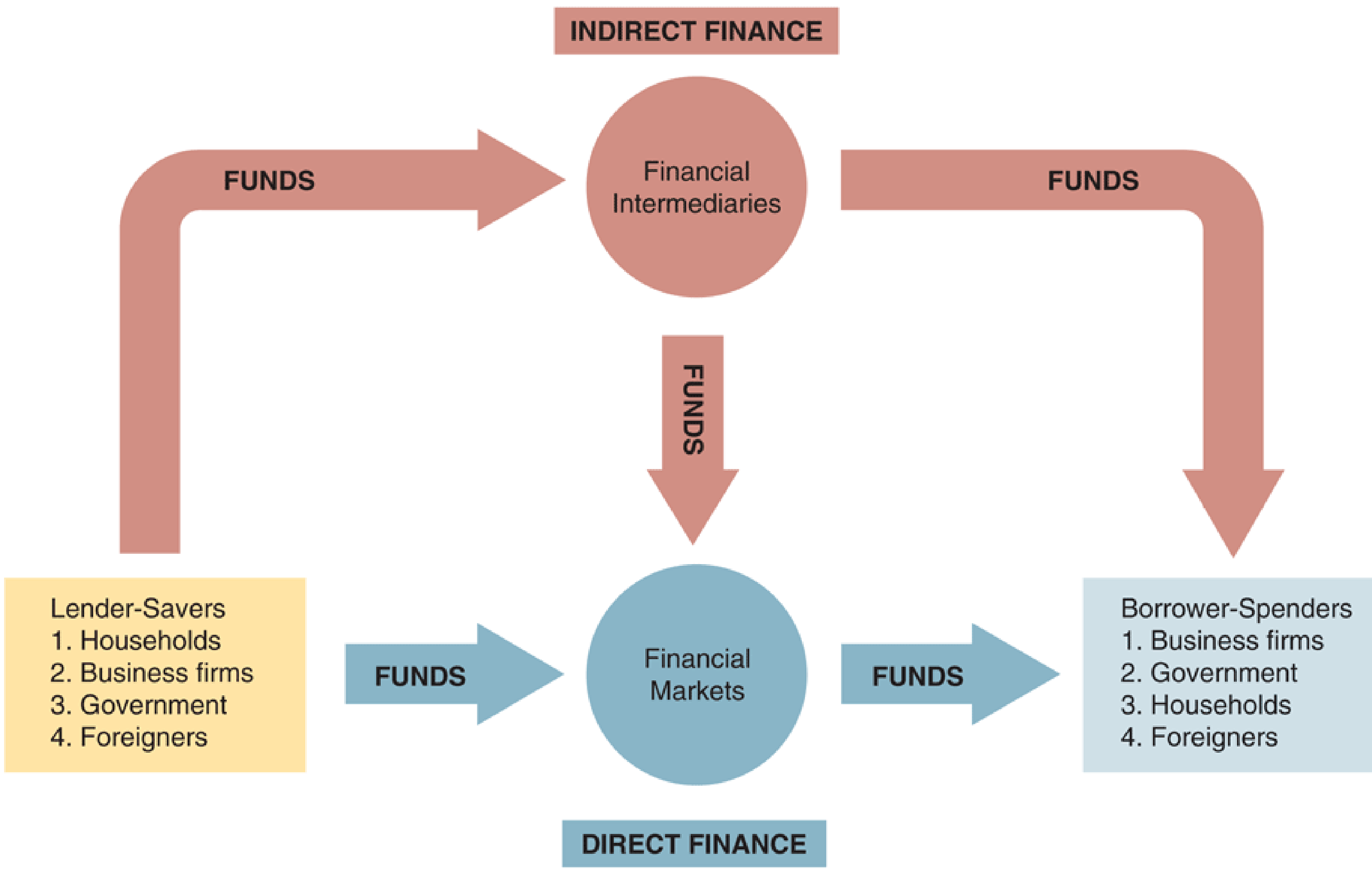
- **Financial System:** is a set of Financial Markets, Financial institutions, and Regulatory and supervisory bodies.
- **Financial markets:** are markets in which funds are transferred from people and Firms who have an excess of available funds to people and Firms who have a need of funds.

2. Functions of Financial Markets

Figure 1: Flows of Funds Through the Financial System



2. Functions of Financial Markets

Segments of Financial Markets

Direct Finance

- Borrowers borrow **directly** from lenders **in financial markets** by selling financial instruments which are claims on the borrower's future income or assets.

Indirect Finance

- Borrowers borrow **indirectly** from lenders **via financial intermediaries** (established to source both loanable funds and loan opportunities) by issuing **financial instruments** which are claims on the borrower's future income or assets.

2. Functions of Financial Markets

- Perform the **essential function of channeling funds** from economic players that have saved surplus funds to those that have a shortage of funds.
- Promotes **economic efficiency** by producing an efficient allocation of capital, which increases production.
- Directly **improve the well-being of consumers** by allowing them to time purchases better.

3. Structure of Financial Markets

There are several basis for classification of Financial Markets:

3.1 Financial instrument

- Debt instrument.
- Equity instrument.

3.2 Maturity Date

- Capital Market.
- Money Market.

3.3 Security Issue

- Primary Market.
- Secondary Market.

3. Structure of Financial Markets

3.1 Debt versus Equity markets

- **Debt Instruments:**

  is a **contractual agreement** by the borrower to pay the holder of instrument **fixed amount** (interest *principal payment) at **regular interval** until a **specific date**, then final payment is made.

Types of Debt instruments:

- Short-Term (maturity < **1 year**)
- Long-Term (maturity > **10 year**)
- Intermediate term (**1-10**).

3. Structure of Financial Markets

3.1 Debt versus Equity markets

- **Equity Instruments:**
  - **Example:** common stock.
  - **Definition**: are claims to share in the net income (income after expenses and taxes) and the assets of a business.
  - Periodic payments: (**dividends**).
  - **No maturity date**.
  - **Adv.: O**wning stock means that you own **a portion of the firm** and thus have the **right to vote** on issues important to the firm and to **elect its directors.**

3. Structure of Financial Markets

3.2 Classifying Markets by Maturity of the Securities:

❑ **Money Market**: **Short-Term** (<= 1 year)

- Is financial market in which **short –term debt instrument** are traded.
- Liquidity and safety of these instruments.
- Are held by corporations and banks

Capital Market: Long-Term (> 1 year).

- Is financial market in which **long–term equity and debt instrument** are traded such as **stock and long-terms bonds**
- are held by financial intermediaries such **insurance and pension funds**.

3. Structure of Financial Markets

3.3 Classifying Markets by Security Issue.

- **Primary Markets: (New securities)**
  - is a financial market in which **new issues of a security** are sold to **initial buyers** by the corporation or government agency borrowing the funds.
  - **Investment Banks: underwrite** securities in primary markets, **advising** company about market timing, **administrative functions** as in help with all legal paper and registration statements with stock market.

3. Structure of Financial Markets

3.3 Classifying Markets by Security Issue.

- **Secondary Market: (Previously issued)**
  - is a financial market in which securities that have been previously issued can be resold.
  - Brokers and dealers work in secondary markets.

Brokers: are agents of investors who make trade on behave of others.

Dealers: are person who trade business on their own.

4. Instruments of financial markets

Financial Instruments

- Money market instruments
  - Treasury bills
  - Certificates of deposits
  - Repurchase agreements
  - Commercial papers
- Capital market instruments
  - stocks
  - mortgages
  - Corporate bonds
  - Government securities
  - Consumer and bank commercial loans

4. Instruments of financial markets

Money Market instruments

Treasury bills is a debt security that promises to make payments regularly for a specified short period of time.

Certificates of deposits are debt instrument that pays annual interest of a given amount and at maturity pays back the original purchase price .

Commercial papers is a short-term debt instrument issued by large banks and well-known corporations.

Repurchase agreements (Repos) are short-erm loans (usually with a maturity of less than two weeks) for which Treasury bills serve as ***collateral***

4. Instruments of financial markets

Capital Market instruments

Stocks are equity claims on the net income and assets of a corporation.

Mortgages are loans to households or firms to purchase land, housing, or other real structures, in which the structure or land itself serves as collateral for the loans.

Corporate bonds are issued by corporations with very strong credit ratings

Government securities are long-term debt instruments are issued to finance the deficits of the government

Consumer and bank commercial loans are made principally by banks but, in the case of consumer loans, also by finance companies.

5. Types of financial intermediaries

- Financial intermediaries
  - Contractual Savings Institutions (CSIs)
    - Life Insurance Companies
    - Fire and Casualty Insurance Companies
    - Pension and Government Retirement Funds
  - Depository institutions
    - Savings and Loan Associations
    - Commercial banks
    - Credit Unions
    - Mutual Savings Banks
  - Investment intermediaries
    - Finance companies
    - Mutual funds
    - Money market mutual funds
    - Investment Banks

5. Types of financial intermediaries

Depository Institutions (Banks)

Commercial banks

- Raise funds primarily by issuing checkable, savings, and time deposits which are used to make commercial, consumer and mortgage loans
- These banks comprise the largest financial intermediary and have the most diversified asset portfolios

5. Types of financial intermediaries

Depository Institutions (Banks)

Savings and Loan Associations and Mutual Savings Banks

Raise funds primarily by issuing savings, time, and checkable deposits which are most often used to make mortgage and consumer loans, with commercial loans

Credit Unions

issue deposits as shares and are owned collectively by their depositors, most of which at credit unions belong to a particular group, e.g., a company’s workers.

5. Types of financial intermediaries

Contractual Savings Institutions (CSIs)

- All CSIs acquire funds from clients at periodic intervals on a contractual basis and have predictable future payout requirements.

Life Insurance Companies they insure people against financial hazards following a death and sell annuities (pensions).

Fire and Casualty Insurance Companies These companies insure their policyholders against loss from theft, fire, and accidents

Pension and Government Retirement Funds hosted by corporations and state and local governments acquire funds through employee and employer payroll contributions, invest in corporate securities, and provide retirement income via pensions.

5. Types of financial intermediaries

Investment Intermediaries

Finance Companies

sell commercial paper and issue bonds and stocks to raise funds to lend to consumers to buy durable goods, and to small businesses for operations.

Mutual Funds

acquire funds by selling shares to individual investors and use the proceeds to purchase large, diversified portfolios of stocks and bonds.

5. Types of financial intermediaries

Investment Intermediaries

Money Market Mutual Funds

acquire funds by selling checkable deposit-like shares to individual investors and use the proceeds to purchase highly liquid and safe short-term money market instruments.

Investment Banks

Are intermediaries that help a corporation to issue securities by recommending type of securities to issue and help to sell (underwrite) the securities by purchasing them from the corporation at a predetermined price and reselling them in the market.