OVERVIEW OF THE FINANCIAL SYSTEM

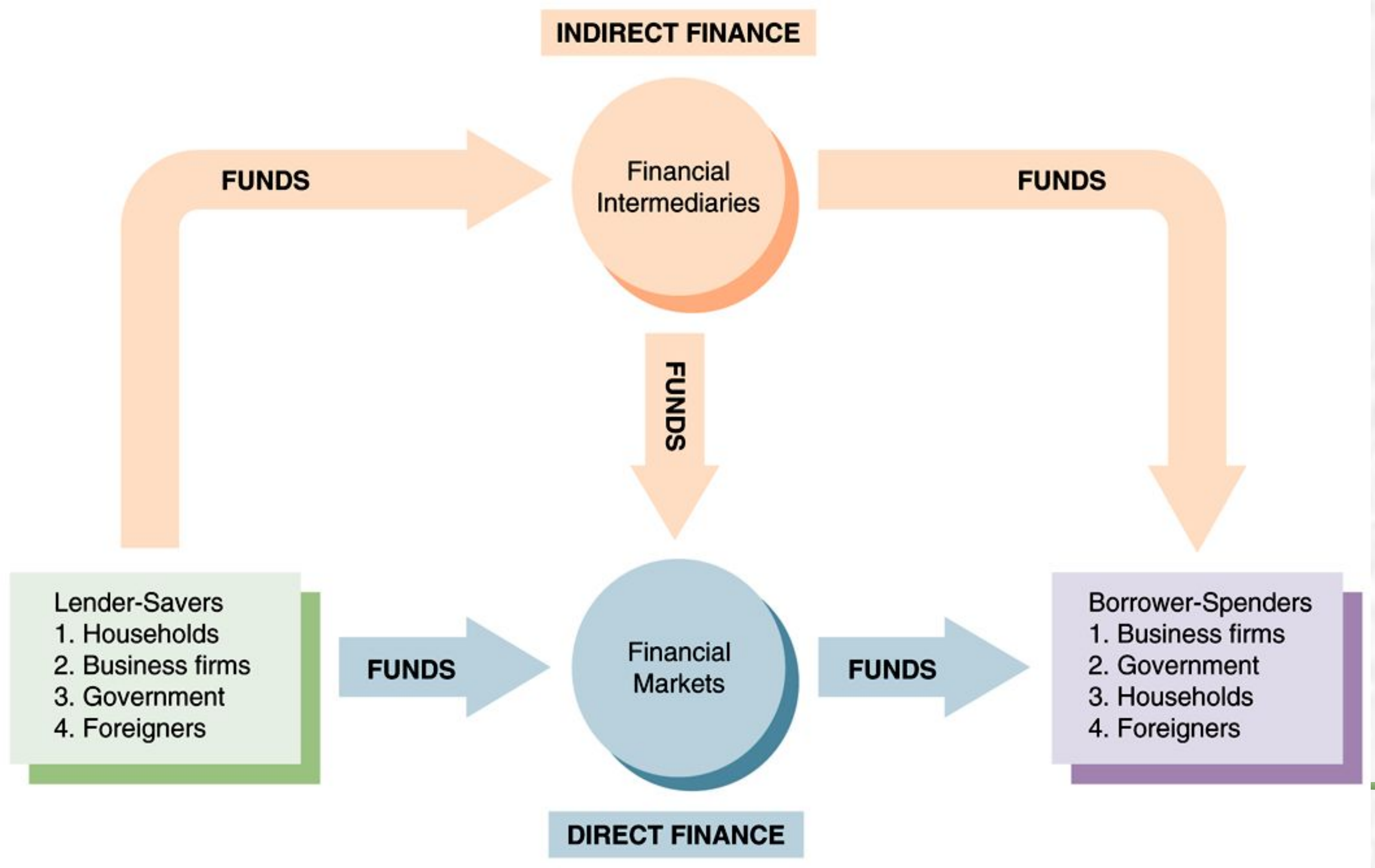
Financial Institutions and Markets

OVERVIEW OF THE FINANCIAL SYSTEM

1. FUNCTION OF FINANCIAL MARKETS
2. STRUCTURE OF FINANCIAL MARKETS
3. FUNCTIONS OF FINANCIAL INTERMEDIARIES
4. TYPES OF FINANCIAL INTERMEDIARIES
5. REGULATION OF FINANCIAL MARKETS

I. 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



II. Classification of Financial Markets

1. Debt Market

   Short-Term (maturity < 1 year)

   Medium-Term (1< maturity < 10 years)

   Long-Term (maturity > 10 years)

2. Equity Market

   - Common/Preferred Stock trading

3. Foreign exchange market

   - trading in international currencies

4. Financial derivatives markets

   -Trading in futures, forwards, options and swap contracts

II. Classification of Financial Markets

1. Money Market
   - the short-term debt instruments with the maturity of less than 1 year

2. Capital Markets
   - the long-term debt instruments with the maturity of more than 1 year and equity instruments

Classification of Financial Markets

1. Primary Market

   New security issues sold to initial buyers

   - Investment Banks underwrites securities

2. Secondary Market

   Securities previously issued are bought and sold

   - Brokers – agents of investors who match buyers with sellers of securities
   - Dealers – link buyers and sellers by buying and selling securities at stated prices

Classifications of Financial Markets

1. Exchanges

   Trades conducted in central locations

   (e.g., New York Stock Exchange, KASE, LSE)

2. Over-the-Counter Markets

   Dealers and Brokers at different locations buy and sell securities

Globalization of Financial Markets

- International Bond Market
  1. Foreign bonds
     – sold in a foreign country and denominated in that country's currency
  2. Eurobonds
     - denominated in a currency other than that of the country in which it is sold
- Eurocurrency
  – deposited in banks outside of home country (eurodollars)
- World Stock Markets
  - the U.S. stock market is no longer the largest: the Japan's one is the largest

III. Functions 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

Function of Financial Intermediaries

- A financial intermediary's low transaction costs mean that it can provide its customers with **liquidity services**, services that make it easier for customers to conduct transactions
  1. Banks provide depositors with checking accounts that enable them to pay their bills easily
  2. Depositors can earn interest on checking and savings accounts and yet still convert them into goods and services whenever necessary

Function of Financial Intermediaries

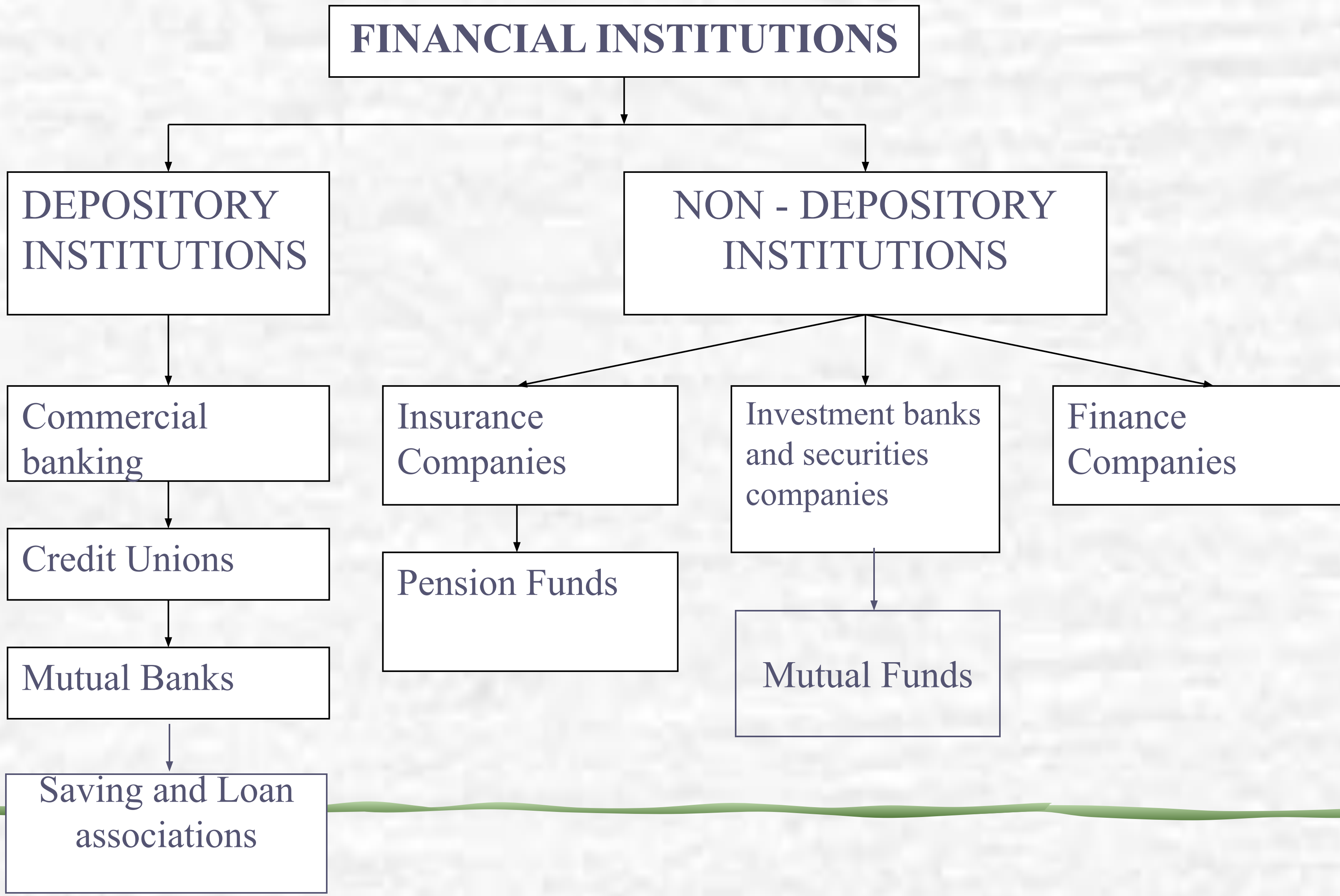
- Another benefit made possible by the FI’s low transaction costs is that they can help reduce the exposure of investors to risk, through a process known as **risk sharing**
  - FIs create and sell assets with lesser risk to one party in order to buy assets with greater risk from another party
  - This process is referred to as **asset transformation**, because in a sense risky assets are turned into safer assets for investors

Asymmetric Information: Adverse Selection and Moral Hazard

- **Adverse Selection**
  - 1. Before the transaction occurs
  - 2. Potential borrowers most likely to produce adverse outcome are ones most likely to seek loan 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

IV. Types of Financial Intermediaries



IV. Types of Financial Intermediaries

TABLE 1 Primary Assets and Liabilities of Financial Intermediaries

Type of Intermediary	Primary Liabilities (Sources of Funds)	Primary Assets (Uses of Funds)
Depository Institutions (Banks)		
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
Contractual Savings Institutions		
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 employee contributions	Corporate bonds and stock
Investment Intermediaries		
Finance companies	Commercial paper, stocks, bonds	Consumer and business loans
Mutual funds	Shares	Stocks, bonds
Money market mutual funds	Shares	Money market instruments

Source: Federal Reserve Flow of Funds Accounts.

Depository institutions:

Significant proportion of their funds comes from deposits.

- **Commercial banks**
  - Money centre banks
  - Wholesale banking
  - Retail banking
- **Credit Unions**
  - Small cooperative lending institutions organized around the particular groups to satisfy the saving and lending needs of the members
- **Saving and Loan associations**
  - long-term residential mortgages and short-term and long term saving deposits

The Largest Banks in the World

(by assets size)

Company	Consolidated assets, $ mill
1. Mizuho Financial Group	1 394 242
2. Deutsche Bank	843 761
3. Citigroup, Inc.	716 937
4. BNP Paribas	701 853
5. Bank of Tokyo Mitsubishi	678 244
6. JP Morgan Chase&Co	667 003
7. HypoVereinsbank	646 003
8. HSBC Holding	638 747

CONTRACTUAL SAVING INSTITUTIONS

Insurance Companies : protection of policyholders from adverse events

- Life/health insurance companies;
- Property/Casualty Insurance.

Source of funds:

- Premiums
- Fees

Funds' distribution:

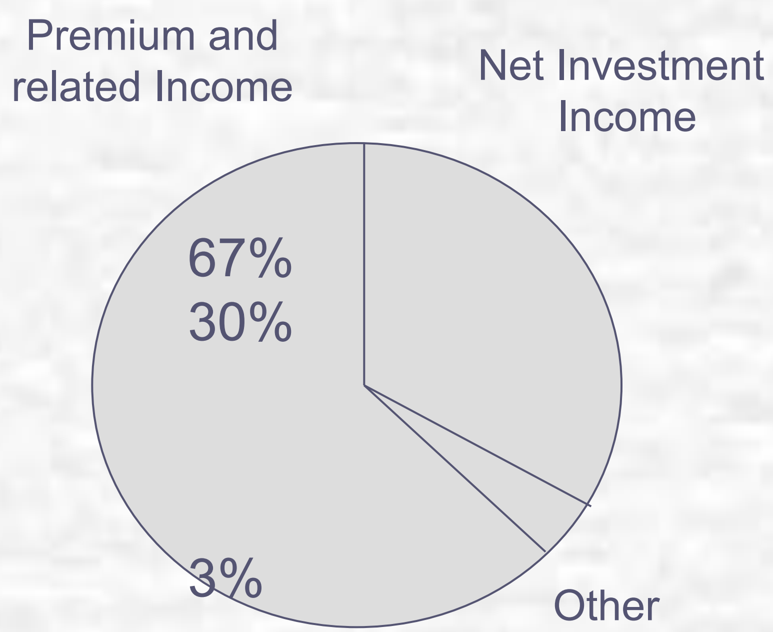
- Long term bonds, equities, government securities, mortgages etc

STRUCTURE OF THE FINANCIAL SERVICIES INDUSTRY

The Biggest US Life Insures

Company	Assets $ bill
Prudential of America	178,62
Metropolitan Life	162,48
Teachers Insurance and Annuity	86,36
New York Life	62,73
North-western Mutual Life	62,68

Sources of Revenue



CONTRACTUAL SAVING INSTITUTIONS

Pension Funds:

- Private and Government organizations that provide financial services for retirement or for the risk of living too long;
- Source of funds: premiums, long term nature of liabilities;
- Distribution of funds: government securities, equities and bonds, real estate etc.

INVESTMENT INTERMEDIARIES

- **Investment Banks** engage in originating, underwriting and distribution of securities’ issue, investing and speculation, corporate finance advising.
- **Security Firms** focus on the purchase, sale and brokerage of securities

INVESTMENT BANKS

Top Underwriters of US Debt and Equity

Company	Assets, $ bill	Market Share, %
Merrill Lynch	208	16.1
Solomon Smith Barney	167	12.9
Morgan Stanley Dean Witter	139	10.8
Goldman Sachs	137	10.6
Lehman Brothers	121	9.4
JP Morgan SEC	104	8.0
Credit Suisse First Boston	68	5.2

INVESTMENT INTERMEDIARIES

Mutual Funds

- Pool the financial resources of individuals and companies and invest in diversified portfolio of assets;
- Provide general information about securities the Mutual Fund hold as assets.

INVESTMENT INTERMEDIARIES

Types of Mutual Funds:

- **Short - term Funds:**
  - Money Market Mutual Funds (MMMFs)
- **Long - term Funds:**
  - Bond and income funds (comprised of fixed income securities)
  - Equity funds (comprise of common and preferred equities)
- **Open-ended Mutual Funds** (no fixed amount of capital)
- **Close-ended Mutual Funds** (have fixed quantities of shares outstanding at any given time)

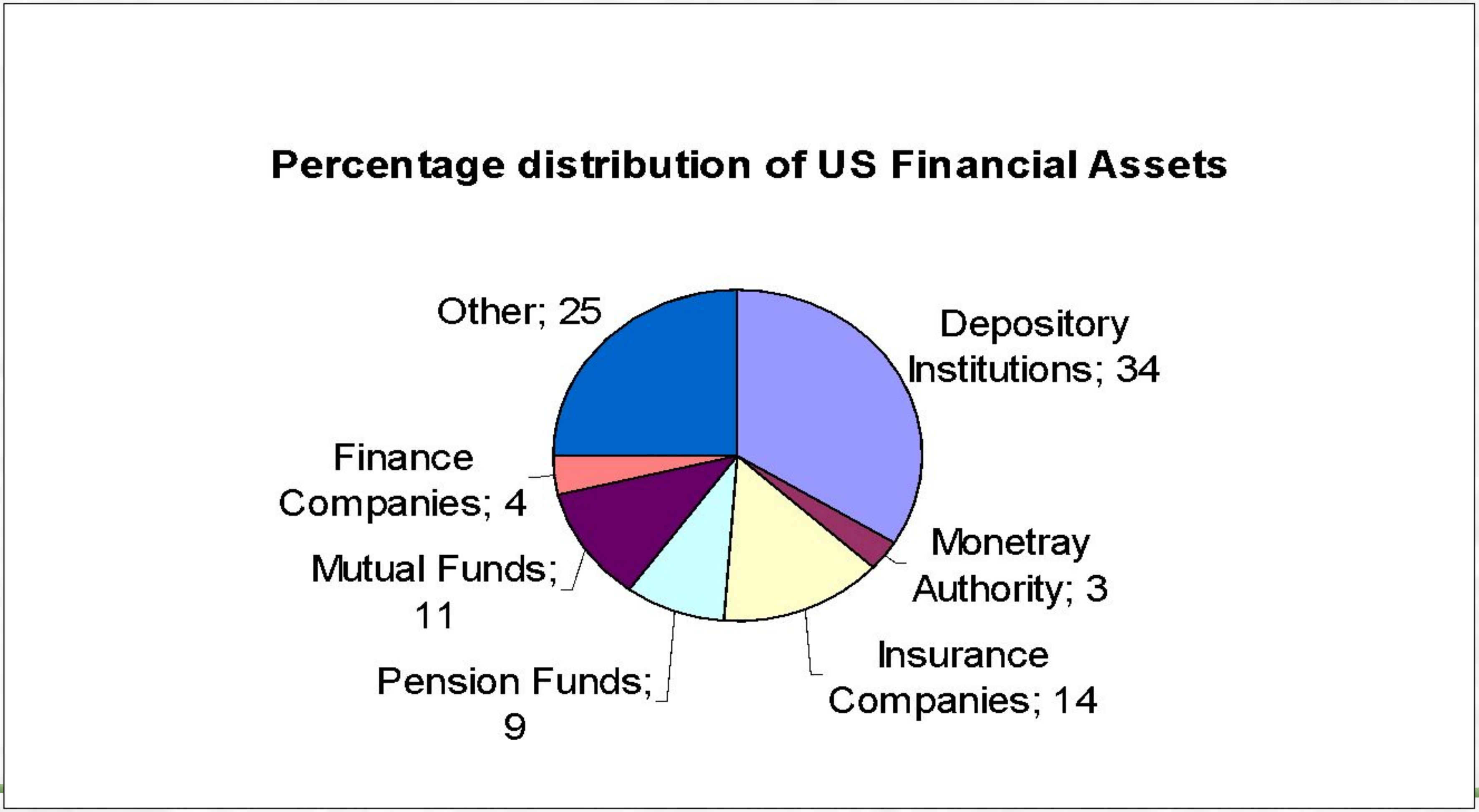
INVESTMENT INTERMEDIARIES

Finance Companies

- Do not accept deposits but rely on short and long-term debt;
- Make loans to individuals and corporations (often lend to customers that banks consider too risky)

Examples: General Motors, Ford Motors and Chrysler Fin Corp., General Electric Capital Services etc.

STRUCTURE OF THE FINANCIAL SERVICIES INDUSTRY



V. Regulation of Financial Markets

Three 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
    C. Deposit insurance to prevent bank panics

3. Improving Monetary Control
    A. Minimum Reserve requirements for banks

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	Charter and examine the books of state-chartered banks and insurance companies, impose restrictions on assets they can hold, and impose restrictions on branching
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

I. Structure of the Financial System

- Ministry of Finance
- KASE
- Agency for Fin. Regulation
- Other financial institutions:
  - 37 Insurance Companies
  - 14 Pension Funds
  - 10 Asset Management Co
  - Securities Firms
  - Mutual Funds etc

- 2 TIER BANKING SYSTEM:
  - 1 tier: NBRK
    - 2 tier: All commercial banks
      - 33 Local banks
      - 14 Foreign banks
      - 2 Inter-State Bank
- 1 State-owned bank (not commercial and do not belong to Tier 2)