CONTENTS

Chapter 1 – Overview

Learning Objectives

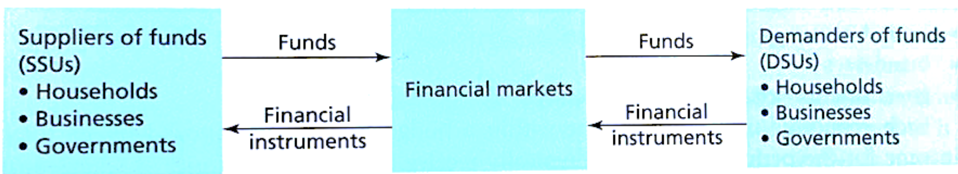
- Explain the role of the financial system and its importance to individuals and to the economy
- Explain the function of direct and indirect financial markets and the key services provided by financial intermediaries
- Describe the various types of financial markets
- Explain the economic function of the money markets and identify the most important money market securities
- Explain the economic function of the capital markets and the most important capital market securities
- Identify the key risks that financial institutions face and describe how they manage these risks

Role of the financial system

- The financial system consists of financial markets, institutions and money
- Financial markets: the markets for buying and selling financial instruments such as stocks, bonds, futures contracts or mortgaged-backed securities
- The roles of the financial system are to:
    - Facilitate the flow of funds
    - Provide the mechanism to settle transactions
    - Generate and disseminate information
    - Provide the means to transfer and manage risk
    - Provide ways of dealing with incentive problems

The flow of funds

- The financial system allows the flow of funds from savers or surplus spending units (SSUs), to borrowers, or deficit spending units (DSUs).
- Surplus spending unit (SSU): an economic unit whose income in a period exceeds expenditure (mainly households). SSUs often purchase financial claims issued by DSUs.
- Deficit spending unit (DSU): an economic unit whose expenditure in a period exceeds income (mainly business firms and governments). A DSU sells financial claims on itself (liabilities) or sells equity to obtain needed funds
- An efficient flow and allocation of funds from SSUs to DSUs is a fundamental function of the financial system.



Economic units

- All economic units can be classified into one of the following groups:
    - Households

    - Businesses
    - Governments (local, state and federal)
- Each economic unit must operate within a budget constraint imposed by its total income for the period.
- Households typically receive income in the form of wages and then make frequent expenditures for food, clothing medical needs, entertainment, education, taxes and housing.
- Businesses sells a variety of goods and services to households and other businesses for revenues and spend their money on paying wages, buying inventory and meeting other business expenses.
- Government units obtain income by collecting taxes and fees and spend on a wide range of services such as health, welfare, education, police, the fire service and defence.
- Any economic unit can have one of three possible budget positions:
    - A balanced budget position: income and planned expenditures are equal
    - A surplus position: income for the period exceeds planned expenditure
    - A deficit position: planned expenditure for the period exceeds income

Financial claims

- The problem facing the financial system is how to transfer the SSUs excess purchasing power to the DSUs that wish to borrow to finance current expenditure
- The transfer can be achieved by an SSU lending money to and accepting a financial claim from a DSU.
- Financial claims are written promises to pay a specific sum of money (the principal) plus interest for the privilege of borrowing money over a period of time.
- Financial claims are issued by DSUs (liabilities) and purchased by SSUs (assets)
- Financial claims are sourced from
    - Debt funds
    - Equity funds

Settlement of transactions

- Transactions generate transfer of funds that must be settled within the system
- Financial system provides the mechanism for these settlements through what is called the payment system
- Payment system permits the transfer of funds within the financial system

Financial Market Efficiency

Allocational efficiency

- The market situation in which funds are allocated to their highest-value use.
- Meaning, the funds could not have been allocated in any other way that would have made society better off.
- The practical implications is that business firms invest in the projects offering the highest risk-adjusted rates of return, and that households invest in direct or indirect financial claims offering the highest yields for given levels of risk.

Informational efficiency

- The market situation in which market prices reflect all relevant information about the securities.
- Large profits can be earned by identifying overpriced securities before the price begins to rise. The actions of analysts and investors ensure that market prices reflect all information relevant to their values at any times.
- With accurate price information, investors can determine which investments are the most valuable – providing the highest expected return for a given level of risk – and invest accordingly
- Informational efficiency ensures that the financial markets are allocationally efficient because households or business firms can get the information they need to make intelligent investment decisions.

Operational efficiency

- The market situation in which the costs of conducting transactions are as low as possible
- Transaction costs include broker commissions, bid-ask spreads and underwriter spreads
- Operational efficiency is important because fewer financial transactions will take place and more otherwise valuable investment projects will be passed up if transaction costs are high.

Transferring Funds From SSUs to DSUs

- The purpose of the financial system is to transfer funds from SSUs to DSUs as efficiently as possible, at the least possible cost and the least inconvenience.
- The job of bringing DSUs and SSUs together can be done by direct financing or by indirect financing, more commonly called financial intermediation.

Direct financing

- In direct financing, DSUs and SSUs exchange money and financial claims directly.
- DSUs issue financial claims on themselves and sell them directly to SSUs for money. The SSUs hold the financial claims in their portfolios as interest-bearing assets
- The financial claims are bought and sold in financial markets, typically in direct credit markets, such as the money or capital markets.
- Private placements
  - The distribution of equity securities in which the investment banker acts only as the company's agent and receives a commission for placing the securities with investors.
  - The advantage of a private placement is the speed with which funds can be committed and the low transaction cost of bringing the securities to market.
- Brokers and dealers
  - Brokers: those who act as intermediaries between buyers ad sellers but do not take title to the securities traded