

Introduction to Financing

Prepared by Dr. Sara Ahmed

MGM 611

Orientation Lecture





مجموعة جامعة
الجميع الذكية
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MIDOCEAN
UNIVERSITY
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LEARNING OBJECTIVES

- Differentiate between primary and secondary markets
- Differentiate between money and capital markets
- Understand the concept of foreign exchange markets
- Understand the concept of derivative security markets
- Distinguish between the different types of financial institutions
- Know the services financial institutions perform
- Know the risks financial institutions face
- Appreciate why financial institutions are regulated
- Recognize that markets are become increasingly global

Why Study Financial Markets and Institutions?

- Markets and institutions are primary channels through which capital is allocated in our society
 - Investment and financing decisions require managers and individual investors to understand the flow of funds throughout the economy
 - Managers and individuals must also understand the operation and structure of domestic and international financial markets

Financial Markets

- Financial markets are structures through which funds flow
- Financial markets can be distinguished along two major dimensions:
 - Primary versus secondary markets
 - Money versus capital markets

Primary versus Secondary Markets

- **Primary markets**

- Markets in which users of funds (e.g., corporations) raise funds through new issues of financial instruments, such as stocks and bonds
- Include issues of equity by firms initially going public, referred to as *initial public offerings (IPOs)*

- **Secondary markets**

- Markets that trade financial instruments once they are issued

Primary and Secondary Market Transfer of Funds Time Line

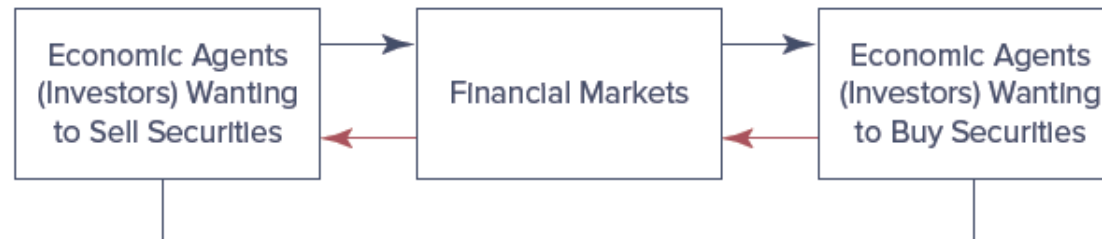
Primary Markets

(Where new Issues of financial Instruments are offered for sale)



Secondary Markets

(Where financial Instruments, once Issued, are traded)



→ Financial Instruments flow

← Funds flow

Primary versus Secondary Markets (Continued)

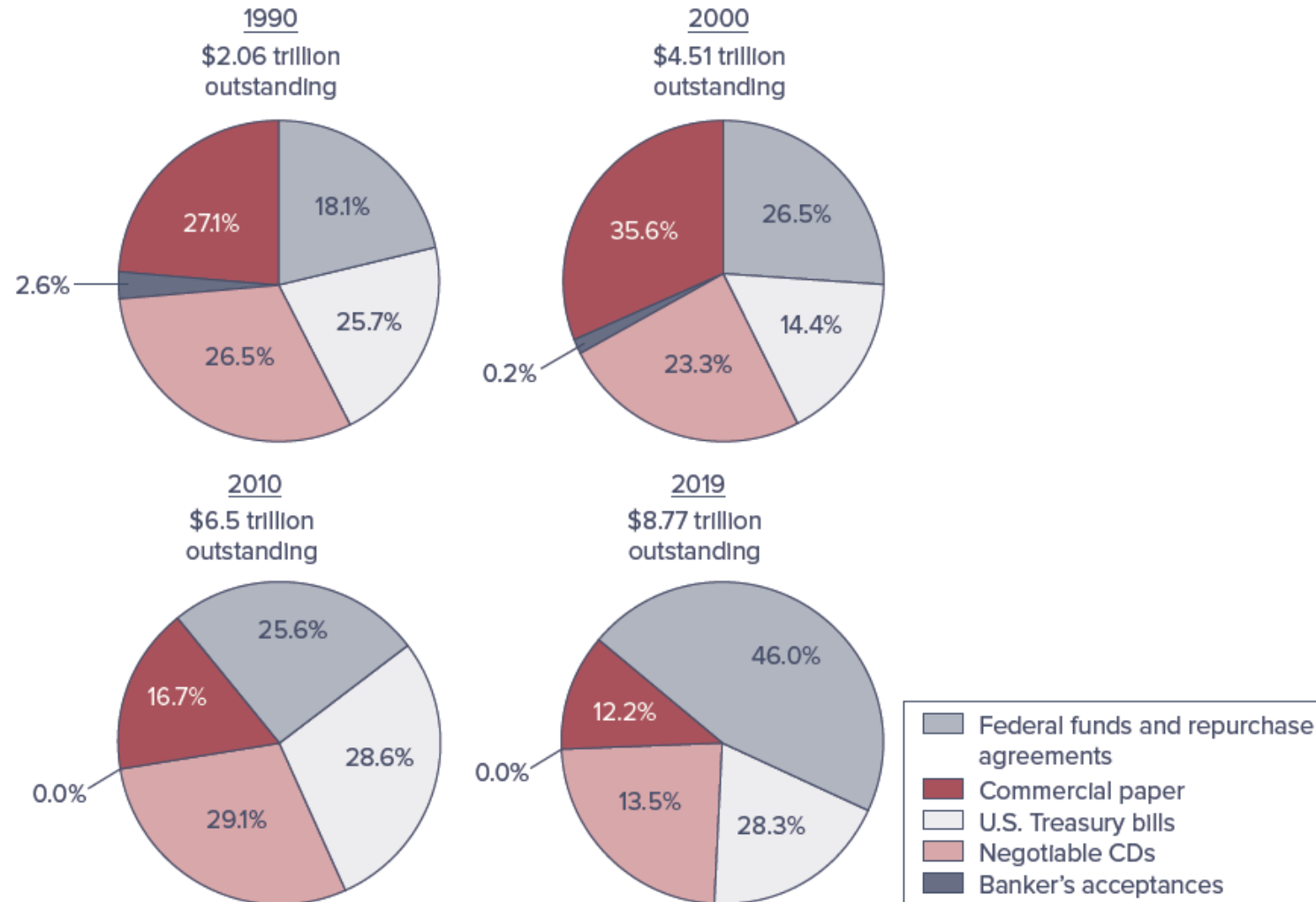
- How were primary markets affected by the financial crisis?
- Secondary markets offer the following:
 - Liquidity, or the ability to turn an asset into cash quickly at its fair market value
 - Information about the prices or the value of investments
 - Trading with low transaction costs

Money versus Capital Markets

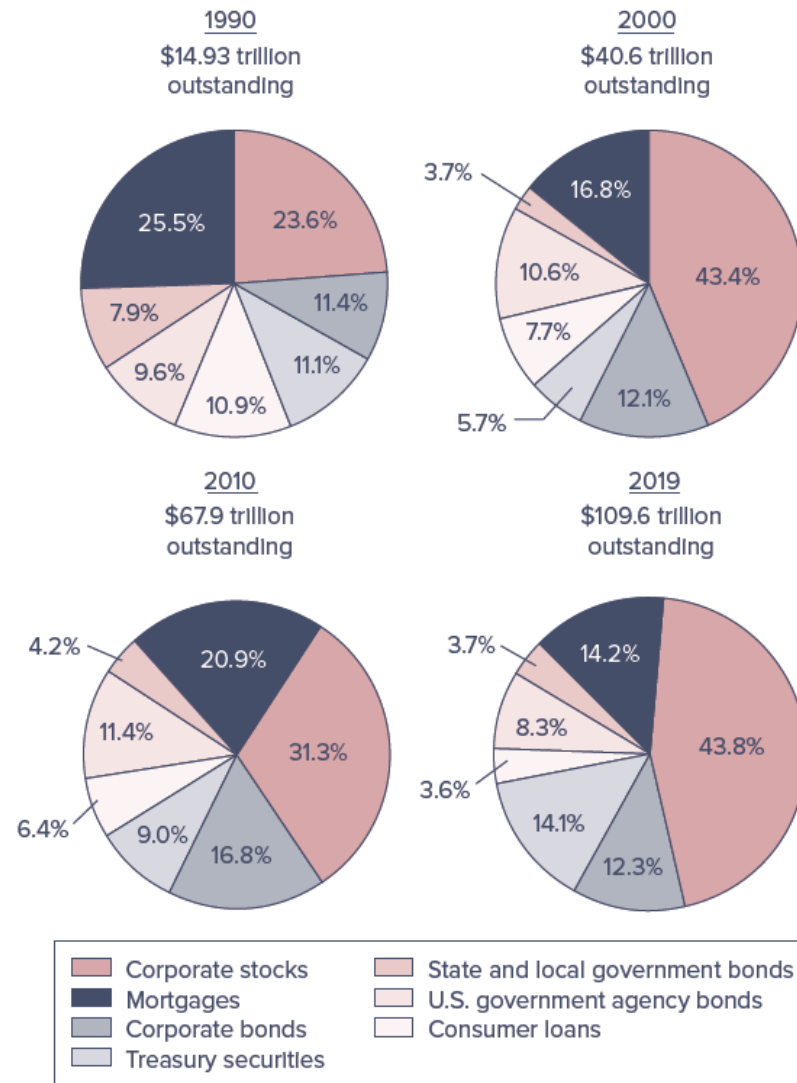
- Money markets trade debt securities or instruments with maturities of one year or less
 - Most U.S. money markets are ***over-the-counter (OTC) markets***
- Capital markets trade debt (bonds) and equity (stocks) instruments with maturities of more than one year
 - Wider price fluctuations than money market instruments



Money Market Instruments Outstanding



Capital Market Instruments Outstanding



Foreign Exchange Markets

- *Foreign exchange risk* is the sensitivity of the value of cash flows on foreign investments to changes in the foreign currency's price in terms of dollars
 - U.S. dollars received on a foreign investment depends on the exchange rate between the U.S. dollar and the foreign currency when the nondollar cash flow is converted into U.S. dollars

Derivative Security Markets

- A **derivative security** is a financial security (e.g., future, option, swap, or mortgage-backed security) whose payoff is linked to another, previously issued security, such as a security traded in capital or foreign exchange markets
 - Derivatives are traded in **derivative security markets**
 - Generally involves agreement between two parties to exchange a standard quantity of an asset or cash flow at a predetermined price and at a specified future date
 - Derivative markets are the newest of financial security markets and are also potentially the riskiest security

Derivative Security Markets (Continued)

- Derivative activity:
 - Tremendous growth between 1992-2013
 - Large drop from 2013 to 2019, due largely to the 2014 implementation of the Volcker Rule

TABLE 1-4 Derivative Contracts Held by Commercial Banks, by Contract Product
(in billions of dollars)

	1992	2000	2008	2013	2016	2019
Futures and forwards	\$4,780	\$ 9,877	\$ 22,512	\$ 45,599	\$ 35,685	\$ 46,165
Swaps	2,417	21,949	131,706	138,361	107,393	106,837
Options	1,568	8,292	30,267	33,760	30,909	44,134
Credit derivatives	—	426	15,897	13,901	6,986	4,145
Total	\$8,765	\$40,544	\$200,382	\$231,621	\$180,973	\$201,281

Note: Em dashes represent values that are too small to register.

Sources: Office of the Comptroller of the Currency website, various dates, [www.occ.treas.gov](http://www OCC.treas.gov)

Financial Market Regulation

- Financial instruments are subject to regulations imposed by regulatory agencies, such as the Securities and Exchange Commission (SEC)
 - Main emphasis of SEC regulations is on full and fair disclosure of information on securities issues to actual and potential investors
 - SEC monitors trading on the major exchanges to ensure stockholders and managers do not trade on inside information about their own firms

Overview of Financial Institutions (FIs)

- **Financial institutions** perform the essential function of channeling funds from those with surplus funds to those with shortages of funds
- In a world without FIs, the level of funds flowing between suppliers and users would likely be quite low due to the following reasons:
 - Monitoring costs
 - Liquidity costs
 - **Price risk**

Types of Financial Institutions

Commercial banks—depository institutions whose major assets are loans and whose major liabilities are deposits. Commercial banks' loans are broader in range, including consumer, commercial, and real estate loans, than are those of other depository institutions. Commercial banks' liabilities include more nondeposit sources of funds, such as subordinate notes and debentures, than do those of other depository institutions.

Thriffs—depository institutions in the form of savings associations, savings banks, and credit unions. Thriffs generally perform services similar to commercial banks, but they tend to concentrate their loans in one segment, such as real estate loans or consumer loans.

Insurance companies—financial institutions that protect individuals and corporations (policyholders) from adverse events. Life insurance companies provide protection in the event of untimely death, illness, and retirement. Property casualty insurance protects against personal injury and liability due to accidents, theft, fire, and so on.

Securities firms and investment banks—financial institutions that help firms issue securities and engage in related activities such as securities brokerage and securities trading.

Finance companies—financial intermediaries that make loans to both individuals and businesses. Unlike depository institutions, finance companies do not accept deposits but instead rely on short- and long-term debt for funding.

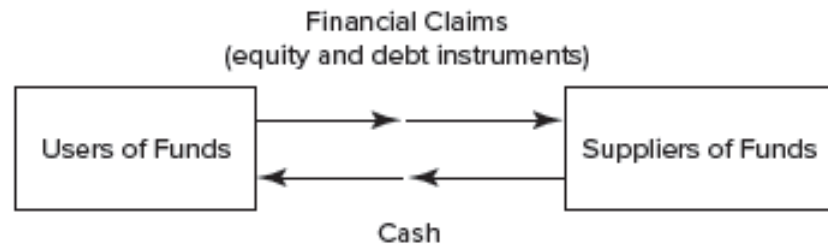
Investment funds—financial institutions that pool financial resources of individuals and companies and invest those resources in diversified portfolios of assets.

Pension funds—financial institutions that offer savings plans through which fund participants accumulate savings during their working years before withdrawing them during their retirement years. Funds originally invested in and accumulated in pension funds are exempt from current taxation.

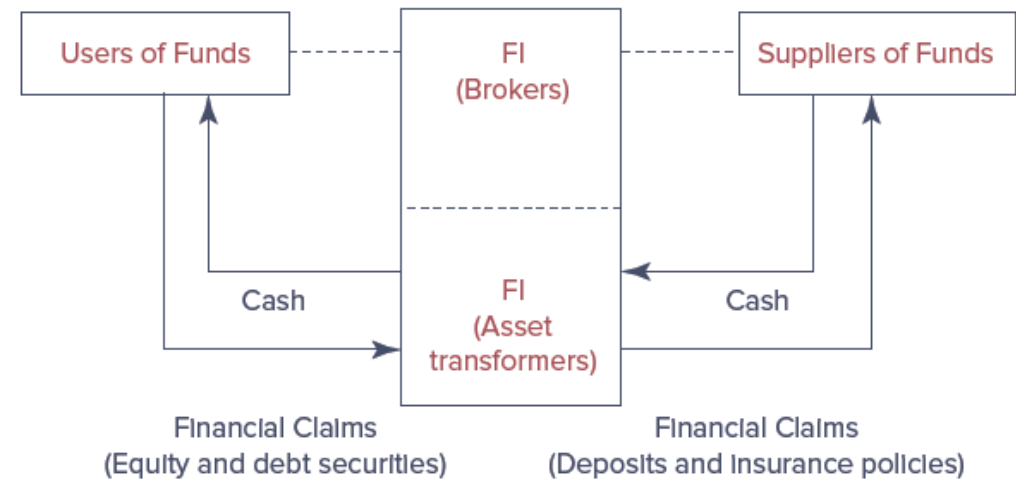
FinTechs—institutions that use technology to deliver financial solutions in a manner that competes with traditional financial methods.

Flow of Funds

Flow of Funds in a World without FIs



Flow of Funds in a World with FIs



Monitoring Costs

- A supplier of funds who directly invests in a fund user's financial claims faces a high cost of monitoring the fund user's actions in a timely and complete fashion
 - A solution is for many small investors to group their funds together by holding the claims issued by a FI (i.e., aggregation of funds)

Liquidity and Price Risk

- FIs act as **asset transformers**, financial claims issued by an FI that are more attractive to investors than are the claims directly issued by corporations
- Often, claims issued by FIs have liquidity attributes that are superior to those of primary securities
- FIs **diversify** away some, but not all, of their investment risk

Additional Benefits and Functions of FIs

- Additional benefits FIs provide to suppliers of funds:
 - Reduced transaction cost
 - Maturity intermediation
 - Denomination intermediation

Risks Incurred by Financial Institutions

- FIs face various types of risks:
 - Default risk (i.e., credit risk)
 - Foreign exchange risk and country (i.e., sovereign) risk
 - Interest rate risk
 - Market risk, or asset price risk
 - Off-balance sheet risk
 - Liquidity risk
 - Technology and operational risk
 - Insolvency risk

Regulation of Financial Institutions

- Failures of FIs can cause widespread panic and withdrawal runs on institutions
 - The 2008 increase in the deposit cap (to \$250,000 per person per bank) was intended to instill confidence in the banking system
- FIs are regulated to prevent market failures, as well as associated costs on the economy and society at large

Trends in the United States

- The following trends are evident in the U.S. between 1948-2019:
 - Share of depository institutions declined from 62.7% to 30.9%
 - Insurance companies also witnessed a decline in their share, from 23.4% to 13.8%
 - Investment companies increased their share from 1.1% to 31.0%, while pension funds increased from 9.1% to 13.2%
 - Overall assets increased from \$0.27t to \$75.21t

Trends in the United States (Continued)

- Rise of financial services holding companies
 - Savers increasingly prefer investments that closely mimic diversified investments in the direct securities markets over the transformed financial claims offered by traditional FIs
- Shift away from risk measurement and management and the financial crisis
 - Under the traditional originate-and-hold banking model, banks may have been reluctant to so aggressively pursue low-credit-quality borrowers for fear of default

Enterprise Risk Management

- **Enterprise risk management**

- Recognizes the importance of managing the combined impact of the full spectrum of risks as an interrelated risk portfolio
- Seeks to embed risk management as a component in all critical decisions throughout FI
- Popularity rose as a result of the failure of advanced risk measurement and management systems to detect exposures that led to the financial crisis
- Stresses importance of building strong risk culture

Fintech

- Financial technology, or fintech, refers to the use of technology to deliver financial solutions in a manner that competes with traditional financial methods
 - Includes services such as cryptocurrencies (e.g., bitcoin) and blockchain
 - Fintech risk involves the risk that fintech firms could disrupt business of financial services firms in the form of lost customers and lost revenue
 - Supports models of peer-to-peer mass collaboration

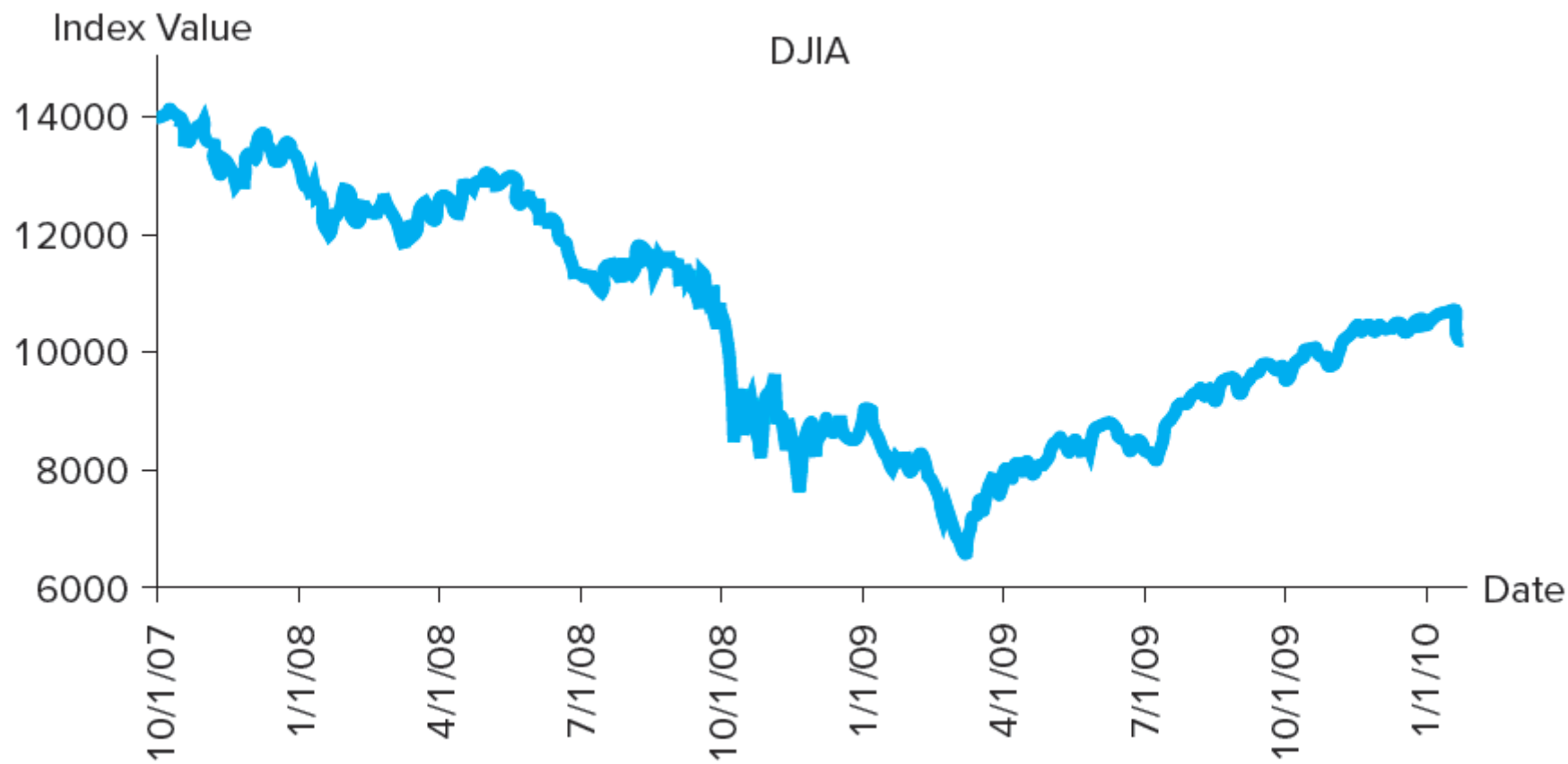
Globalization of Financial Markets and Institutions

- U.S. markets are the world's largest, but international markets have seen rapid growth in recent years as a result of various factors:
 1. Pool of savings in foreign countries has increased
 2. International investors have turned to U.S. and other markets to expand their investment opportunities
 3. Information on foreign investments and markets is now more accessible and thorough
 4. Some U.S. FIs offer their customers opportunities to invest in foreign securities and emerging markets at relatively low transaction costs

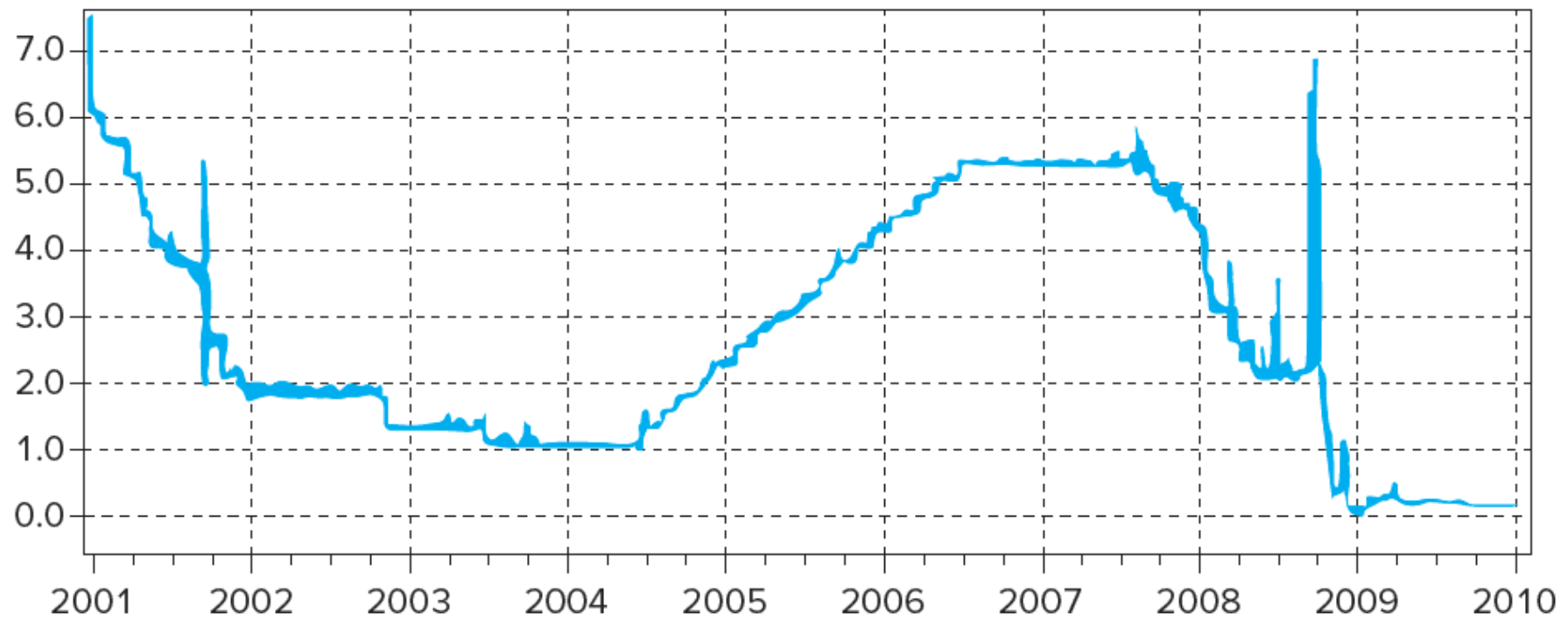
Globalization of Financial Markets and Institutions (Continued)

- U.S. markets are the world's largest, but international markets have seen rapid growth in recent years as a result of various factors:
 5. The euro is having a notable impact on the global financial system
 6. Economic growth in Pacific Basin countries, China, and other emerging countries has resulted in significant growth in their stock markets
 7. Deregulation in many foreign countries has allowed international investors greater access and allowed the deregulating countries to expand their investor base

The Dow Jones Industrial Average, October 2007 – January 2010



Overnight LIBOR, 2001-2010





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