

Lecture 1

- Chapter 1 & Chapter 2 of textbook by Frederic S. Mishkin and Stanley Eakins, Financial Markets and Institutions

Key Terms

- Financial Markets
- Financial Institutions
- Financial System

Main Financial Markets

- Capital Markets (long term financing)
 - Bond Markets
 - Stock Markets
- Foreign Exchange Market
- Commodity Markets
- Future Markets
- Derivative Markets
- Money Markets (short term financing)

Basic Definitions

- Security is a claim on issuer's future income/assets
- Stock is a security that is a claim on the earnings and assets of a corporation
- Bond is a debt security with or without periodic payments throughout time
- Bond market determines interest rates
- Interest rate is the cost of borrowing
- Foreign exchange rate is the price of one country's currency in terms of another one

Debt/Bond Markets

- Issue new debt, primary market, or
- buy & sell debt securities, secondary market
 - securities with active secondary market mean there are many buyers & sellers /liquidity
- Primary goal is to provide a mechanism for long term funding of
 - public &
 - private expenditures

World Bond Markets

<HELP> for explanation.

Regional		97) Settings		99) Feedback		World Bond Markets						
91) Bonds		92) Spreads		93) Curves								
Maturity		10 Year							Data Range		3 Months	
Country	CMI	Security		Price	Chg	Yield	Chg	Yield	Low	Range	High	3M Chg
1) Americas												
10) United States		T 2 1/2 08/23		98-31	+ 10	2.619	-3.6		2,469		2,994	+1.1
11) Canada		CAN1 1/2 06/23		90.970	+0.279	2.560	-3.4		2,351		2,812	+2.6
12) Brazil (USD)		BRAZIL8 7/8 24		138.675	+0.050	4.278	-.7		3,954		4,801	-18.4
13) Colombia (USD)		COLOM 8 1/8 24		131.820	+0.255	4.356	-2.7		3,875		4,901	-13.2
14) Mexico (USD)		MEX8 09/24/22		134.200	-0.400	3.525	+4.1		3,428		4,061	-63.4
2) EMEA												
20) United Kingdom		UKT2 3/4 09/23		95.670 c	+0.340	2.750	-4.0		2,254		3,016	+21.6
21) France		FRTR 1 3/4 23		94.915 c	+0.075	2.344	-.9		2,165		2,624	-10.2
22) Germany		DBR2 08/15/23		101.600 c	+0.205	1.821	-2.3		1,514		2,044	+1.8
23) Italy		BTPS 4 1/2 23		102.410 c	+0.045	4.234	-.6		4,155		4,574	-61.4
24) Spain		SPGB4.4 10/23		101.020 c	-0.085	4.274	+1.0		4,256		4,802	-78.1
25) Portugal		PGB4.95 10/23		86.220 c	+0.145	6.891	-2.1		6,199		7,260	+12.5
26) Sweden		SGB1 1/2 11/23		91.692 c	+0.368	2.436	-4.3		2,043		2,723	+18.5
27) Netherlands		NETHER1 3/4 23		96.055 c	+0.105	2.202	-1.2		1,940		2,460	-5.0
28) Switzerland		SWISS 4 02/23		126.580 c	+0.080	1.010	-1.0		,917		1,133	-4.1
29) Greece		GGB2 02/24/23		61.365 c	+0.775	9.406	-16.5		9,356		11,223	-175.0
3) Asia/Pacific												
30) Japan		JGB 0.8 09/23		101.282 c	--	0.663	--		,663		,884	-18.0
31) Australia		ACGB 5 1/2 23		112.891 c	+0.204	3.873	-2.5		3,588		4,162	+8.1
32) New Zealand		NZGB 5 1/2 23		106.887	+0.325	4.600	-4.1		4,077		4,789	+40.6
33) South Korea		NDFB 3 3/8 23		100.007 c	-0.061	3.392	+8		3,375		3,727	-20.4

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Stock Markets

- Stock market is a public entity for the trading of company stock (shares) listed on a stock exchange
- The stock market is one of the most important sources for companies to raise money
- Allows businesses to be
 - publicly traded, or
 - raise additional financial capital for expansion by selling shares of ownership of the company in a public market

World Equity Indices

<HELP> for explanation, <MENU> for similar functions.

#<Go> for Index Details

95) Settings		96) News		97) Feedback		World Equity Indices		
Standard	Movers	Volatility	Ratios	Futures	AVAT vs	10d	% Ytd	EUR
1) Americas	2day	Value	Net Chg	% Chg	Δ AVAT	Time	% Ytd	% YtdCur
11) DOW JONES		15298.37	-36.22	-0.24%	-29.00%	19:47	+16.74%	+13.90%
12) S&P 500		1694.76 d	-2.66	-0.16%	+5.11%	19:32	+18.83%	+15.93%
13) NASDAQ		3766.98	-1.27	-0.03%	+10.85%	19:47	+24.75%	+21.71%
14) TSX		12853.53 d	+4.64	+0.04%	-6.12%	19:27	+3.38%	-2.96%
15) MEX IPC		41520.15 d	+310.20	+0.75%	+10.89%	19:27	-5.00%	-8.37%
16) IBOVESPA		54200.98	-230.07	-0.42%	-18.56%	19:47	-11.08%	-20.08%
2) EMEA								
21) Euro Stoxx		2927.35 d	+4.42	+0.15%	-0.82%	16:50 c	+11.06%	+11.06%
22) FTSE 100		6551.53 d	-19.93	-0.30%	+3.48%	16:35 c	+11.08%	+7.26%
23) CAC 40		4195.35 d	-.26	-0.01%	-0.47%	17:05 c	+15.22%	+15.22%
24) DAX		8665.63 d	+1.03	+0.01%	+1.75%	17:30 c	+13.84%	+13.84%
25) IBEX 35		9242.90 d	+75.30	+0.82%	+0.37%	16:38 c	+13.17%	+13.17%
26) FTSE MIB		18089.24 d	+24.66	+0.14%	+15.77%	16:30 c	+11.16%	+11.16%
27) AEX		379.60 d	-1.07	-0.28%	-25.64%	17:05 c	+10.76%	+10.76%
28) OMX STKH30		1265.69	-17.04	-1.33%	+138.91%	17:31 c	+14.57%	+13.17%
29) SWISS MKT		8055.23 d	+8.21	+0.10%	-16.69%	16:30 c	+18.07%	+15.99%
3) Asia/Pacific								
31) NIKKEI		14620.53 d	-112.08	-0.76%	-4.52%	07:28 c	+40.65%	+20.86%
32) HANG SENG		23209.63 d	+30.59	+0.13%	-20.30%	09:01 c	+2.44%	-0.11%
33) ASX 200		5275.94	+41.78	+0.80%	-19.92%	09:25 c	+13.49%	-0.33%

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Foreign Exchange Market

- Foreign exchange market is a global decentralized market for the trading of currencies
- The foreign exchange market is the most liquid financial market in the world
- Liquidity refers to the ease a security can be sold without a loss of value

Currency Rates Matrix

<HELP> for explanation, <MENU> for similar functions.

99) Actions Currency Rates Matrix (FXC)

Basket Majors Last Price Rate Spot Date 09/25/2013

Source BGN % Change Outrights Points

	10) Spot	11) Forward	12) Fixing	☒ Heat Map							
	 USD	 EUR	 JPY	 GBP	 CHF	 CAD	 AUD	 NZD	 HKD	 NOK	 SEK
SEK	6.4192	8.6798	.06517	10.320	7.0582	6.2246	6.0077	5.2930	.82786	1.0690	-
NOK	6.0047	8.1193	.06097	9.6536	6.6024	5.8226	5.6197	4.9512	.77440	-	.93543
HKD	7.7539	10.485	.07873	12.466	8.5258	7.5189	7.2569	6.3936	-	1.2913	1.2079
NZD	1.2128	1.6399	.01231	1.9498	1.3335	1.1760	1.1350	-	.15641	.20197	.18893
AUD	1.0685	1.4448	.01085	1.7178	1.1749	1.0361	-	.88104	.13780	.17794	.16645
CAD	1.0313	1.3944	.01047	1.6579	1.1339	-	.96515	.85034	.13300	.17174	.16065
CHF	.90946	1.2297	.00923	1.4621	-	.88189	.85116	.74990	.11729	.15146	.14168
GBP	.62201	.84106	.00632	-	.68393	.60316	.58214	.51288	.08022	.10359	.09690
JPY	98.493	133.18	-	158.35	108.30	95.507	92.179	81.213	12.702	16.403	15.344
EUR	.73955	-	.00751	1.1890	.81318	.71714	.69215	.60981	.09538	.12316	.11521
USD	-	1.3522	.01015	1.6077	1.0996	.96969	.93590	.82456	.12897	.16654	.15578

% Change on Day Range

Below -2.5% -0.5% to -2.5% -0.05% to -0.5% -0.05% to 0.05% 0.05% to 0.5% 0.5% to 2.5% Above 2.5%

Rates are from Composite where Bloomberg BGN is not available

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Structure of Financial Markets

- Financial markets can be categorised based on:
 - Method of raising funds (Equity or Debt?)
 - Maturity (long-term >1 year / short-term <1 year)
 - Primary (initial) / secondary (previously issued)
 - Exchange /Over The Counter (OTC)

Exchange vs. OTC

- OTC trading is done directly between two parties, without any supervision of an exchange
- An exchange has the benefit of:
 - mitigating all credit risk concerning the default of one party in the transaction,
 - providing transparency and
 - maintaining the current market price
 - facilitating liquidity
- The OTC market have the benefit of non-standard, tailor made products

Financial Markets

- In financial markets people and entities can trade:
 - financial securities,
 - commodities,
 - and other fungible items of value
 - **at low transaction costs and**
 - **at prices that reflect supply and demand**

Functions of Financial Markets

- Facilitate transfer of economic resources from lenders to ultimate borrowers
- Provide borrower funds for investment
- Allow lenders to earn interest or dividend
- Provide liquidity in the market
- Facilitate credit creation
- Promote savings and investment
- Facilitates balance economic growth
- Produce efficient allocation of capital
- Promote economic efficiency
- Enhance individual and national income/product

Financial Crisis

- When financial markets break down during financial crises severe economic hardship follows:
 - sharp declines in asset prices
 - failure of firms
 - possible political instability

Financial Institutions

- Financial institutions are what makes financial markets work...
- The financial system is complex & consists of many institutions such as:
 - Banks,
 - Insurance companies,
 - Mutual funds
 - The central bank (responsible for monetary policy)
 - Investment banks, etc.
- Financial institutions are regulated by the government

Financial Intermediaries

- Financial intermediary is a financial institution that connects surplus and deficit agents.
- Channel funds from people with extra money or surplus savings (savers) to those who don't (borrowers)
- Typically the channelling of funds is indirectly (financial intermediation)
- Alternatively, directly via the financial markets, (financial **dis**intermediation)

Financial Intermediaries

- Provide maturity and risk transformation
- Have cost advantage in offering financial services, which
 - enables them to make profit, and
 - also raises the overall efficiency of the economy
- Reconcile conflicting preferences of lenders and borrowers
- Risk aversion; help spread out and decrease the risks
- Economies of scale; reduces the costs of lending and borrowing

Types of Financial Intermediaries

- Depository Institutions
 - Commercial banks
- Contractual Savings Institutions
 - Life insurance companies
 - Casualty insurance companies
 - Pension funds
- Investment intermediaries
 - Finance companies
 - Mutual funds
 - Investment banks

Asymmetric information

- Asymmetric information: decisions in transactions where one party has more or better information than the other
- Consequence: can cause transactions to go awry
- Examples of this problem are:
 - adverse selection
 - moral hazard

Adverse Selection/Moral Hazard

- Adverse selection: undesired results occur when buyers and sellers have asymmetric information **before** the transaction takes place
- Moral hazard may occur where the actions of one party may change to the detriment of another **after** a financial transaction has taken place

Regulation of the Financial System

- Regulation can:
 - increase information available to investors
 - reduce adverse selection & moral hazard problems
- Financial regulation subjects financial institutions to certain requirements, restrictions & guidelines, to maintain the:
 - soundness of financial intermediaries
 - integrity of the financial system

Regulation of the Financial System

- The objectives of financial regulators are:
 - market confidence
 - financial stability
 - consumer protection
 - reduction of financial crime

Regulation of the Financial System-UK

- The Financial Services Authority (FSA) was a body responsible for the regulation of the financial services industry in UK between 2001- 2013 (April)
- Due to perceived regulatory failure of the banks during the financial crisis of 2007–2008, the government decided to restructure financial regulation and abolish FSA
- Its responsibilities were split between two new agencies (the Prudential Regulation Authority and the Financial Conduct Authority) and the Bank of England

Prudential Regulation Authority (PRA)

- The PRA is a part of the Bank of England and responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms
- It sets standards and supervises financial institutions at the level of the individual firm

Financial Conduct Authority (FCA)

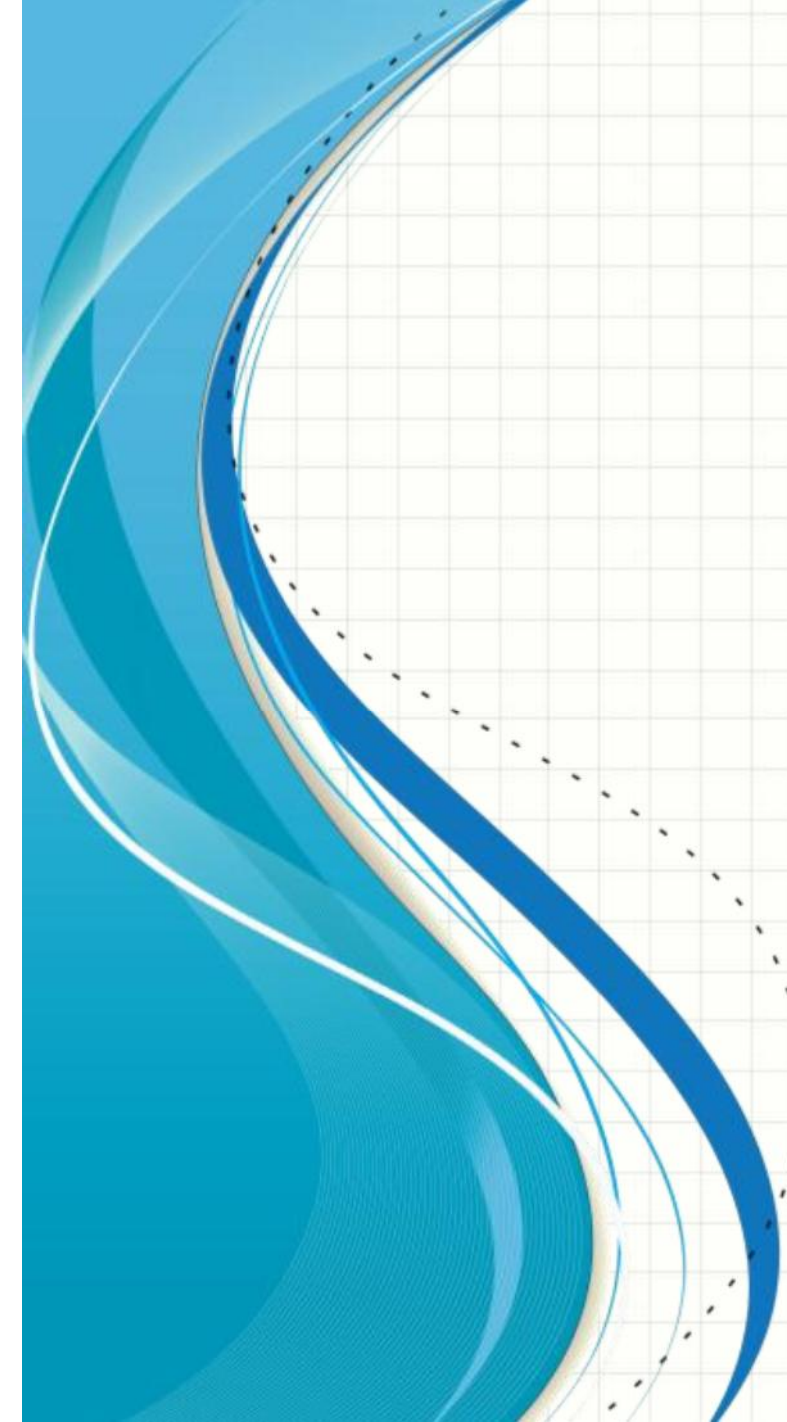
- The (FCA) regulates financial firms providing services to consumers and maintains the integrity of the UK's financial markets
- It is to focus on the regulation of conduct by both retail and wholesale financial services firms

FCA

- The authority has significant powers:
 - regulate conduct related to the marketing of financial products
 - specify minimum standards and to place requirements on products
 - investigate organisation and individuals
 - ban financial products for up to a year while considering an indefinite ban
 - instruct firms to immediately retract or modify promotions which it finds to be misleading, and to publish such decisions

FCA & PRA

- The PRA works alongside the FCA creating a “twin peaks” regulatory structure in the UK
- The FCA is a separate institution and not part of the Bank of England
- The FCA is responsible for promoting effective competition, ensuring that relevant markets function well, and for the conduct regulation of all financial services firms
- This includes acting to prevent market abuse and ensuring that consumers get a fair deal from financial firms
- The FCA operates the prudential regulation of those financial services firms not supervised by the PRA, such as asset managers and independent financial advisers



QUESTIONS