Chapter 2: Part A

An Overview of the Financial System

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What’s an Asset?

- **Asset:** Anything of durable value, such as land, people ("human capital"), bonds,..

- **Real Asset:** An asset in physical form

- **Financial Asset:** A direct or indirect claim against real assets
  - **Direct-Claim Example:** Stock share (firm owner)
  - **Indirect-Claim Example:** Bond (claim to future income arising from real assets of bond issuer)
Financial Markets & Institutions

- **Financial Market:** Any market in which financial assets (either newly issued or previously existing) are traded.

- **Financial Institution:** Any organization that provides financial services for its clients or members.

  - *Example:* A financial intermediary that matches borrowers with lenders.
Six Functions of Financial Markets

• Channel funds from savers (lenders) to those with a shortage of funds (borrowers)
• Determination of asset prices (valuations)
• Information aggregation & coordination
• Risk sharing
• Liquidity
• Efficiency (non-wastage of resources)
Key Players in Financial Markets

- Brokers
- Dealers
- Investment bankers
- Financial intermediaries
Distinctive Attributes of Brokers

- Commissioned agent of a buyer (or seller)
- Facilitates trade by buyer-seller matching
- Does not take a position in the assets he or she trades (no inventory)
- Profits determined by commissions charged to buyers and/or sellers

*Examples:* Real estate broker, Stock broker
Distinctive Attributes of Dealers

- Facilitates trade by buyer-seller matching
- Can and does take positions in the assets he or she trades (maintains inventories)
- Makes profits by buying low and selling high

**Examples:**
- New/used car dealers
- Nasdaq stock dealers
Investment Bank Attributes

- Assists in **Mergers & Acquisitions (M&A)**
- Assists in **Initial Public Offerings (IPOs)**, i.e., the initial sale of newly issued securities (stocks and bonds), by
  - Offering advice
  - Underwriting (guaranteeing issuers a price on offered securities)
  - Sales assistance

- Collapse of U.S. investment banks in 2008
  (*Times Online*, September 22, 2008)

  “Bear Stearns and Lehman Brothers, both investment banks, have collapsed, Merrill Lynch was acquired by Bank of America last weekend, and Goldman Sachs and Morgan Stanley have changed their status (to bank holding companies).”
Distinctive Attributes of a Financial Intermediary (FI)

• Transfers funds from savers to borrowers

• Engages in **asset transformation**: buys one type of financial asset from savers and sells different type of financial asset to borrowers

• Holds portfolios of financial assets for investment, not simply as inventory for resale

• Makes profits from portfolio, plus from low interest rates paid to savers and high interest rates received from borrowers
### Table 3  Primary Assets and Liabilities of Financial Intermediaries

<table>
<thead>
<tr>
<th>Type of Intermediary</th>
<th>Primary Liabilities (Sources of Funds)</th>
<th>Primary Assets (Uses of Funds)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Depository institutions (banks)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commercial banks</td>
<td>Deposits</td>
<td>Business and consumer loans, mortgages, U.S.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>government securities and municipal bonds</td>
</tr>
<tr>
<td>Savings and loan associations</td>
<td>Deposits</td>
<td>Mortgages</td>
</tr>
<tr>
<td>Mutual savings banks</td>
<td>Deposits</td>
<td>Mortgages</td>
</tr>
<tr>
<td>Credit unions</td>
<td>Deposits</td>
<td>Consumer loans</td>
</tr>
<tr>
<td><strong>Contractual savings institutions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Life insurance companies</td>
<td>Premiums from policies</td>
<td>Corporate bonds and mortgages</td>
</tr>
<tr>
<td>Fire and casualty insurance companies</td>
<td>Premiums from policies</td>
<td>Municipal bonds, corporate bonds and stock, U.S.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>government securities</td>
</tr>
<tr>
<td>Pension funds, government retirement funds</td>
<td>Employer and employee contributions</td>
<td>Corporate bonds and stock</td>
</tr>
<tr>
<td><strong>Investment intermediaries</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finance companies</td>
<td>Commercial paper, stocks, bonds</td>
<td>Consumer and business loans</td>
</tr>
<tr>
<td>Mutual funds</td>
<td>Shares</td>
<td>Stocks, bonds</td>
</tr>
<tr>
<td>Money market mutual funds</td>
<td>Shares</td>
<td>Money market instruments</td>
</tr>
</tbody>
</table>
### Table 4  Principal Types of Financial Intermediaries & the Values of Their Assets

<table>
<thead>
<tr>
<th>Type of Intermediary</th>
<th>Value of Assets ($ billions, end of year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depository institutions (banks)</td>
<td></td>
</tr>
<tr>
<td>Commercial banks</td>
<td>1,481</td>
</tr>
<tr>
<td>Savings and loan associations and mutual savings banks</td>
<td>792</td>
</tr>
<tr>
<td>Credit unions</td>
<td>67</td>
</tr>
<tr>
<td>Contractual savings institutions</td>
<td></td>
</tr>
<tr>
<td>Life insurance companies</td>
<td>464</td>
</tr>
<tr>
<td>Fire and casualty insurance companies</td>
<td>182</td>
</tr>
<tr>
<td>Pension funds (private)</td>
<td>504</td>
</tr>
<tr>
<td>State and local government retirement funds</td>
<td>197</td>
</tr>
<tr>
<td>Investment intermediaries</td>
<td></td>
</tr>
<tr>
<td>Finance companies</td>
<td>205</td>
</tr>
<tr>
<td>Mutual funds</td>
<td>70</td>
</tr>
<tr>
<td>Money market mutual funds</td>
<td>76</td>
</tr>
</tbody>
</table>

Basic Types of Financial Markets

Securities Markets:

• **Auction markets:** Conducted by brokers

• **Over-the-Counter (OTC) Markets:** Conducted by dealers

• **Organized Exchanges:** Combine auction and OTC features

Other:

• **Financial intermediation:** conducted by FIs
Distinctive Attributes of Auction markets

- Centralized facility (clearing house) in which brokers execute trades for buyer and seller clients via open competitive bidding process
- Clearing house can be physical or virtual (online site)
- Typically public (open to all agents subject to some eligibility requirements)
- Many forms, such as call (batched matching) & continuous (exchange on continual basis)
Distinctive Attributes of OTC Markets

• No centralized facility for trading

• Consists of a number of dealers spread across a region, a country, or the world

• Each dealer locally “makes a market” by posting buy and sell prices, and by maintaining inventories

**Examples:** Nasdaq, U.S. government bond market, foreign exchange market
Distinctive Attributes of Financial Intermediation

• **Asset Transformation:** FI issues deposit accounts (IOUs) to savers and acquires loan contracts (IOUs) from borrowers

• Deposit accounts are FI liabilities

• Loan contracts are FI assets

• “Maturity gap” problem
  
  — Relatively short maturity on deposit accounts
  
  — Relatively long maturity on loan contracts
  
  — Risk: Depositors might suddenly want to withdraw funds