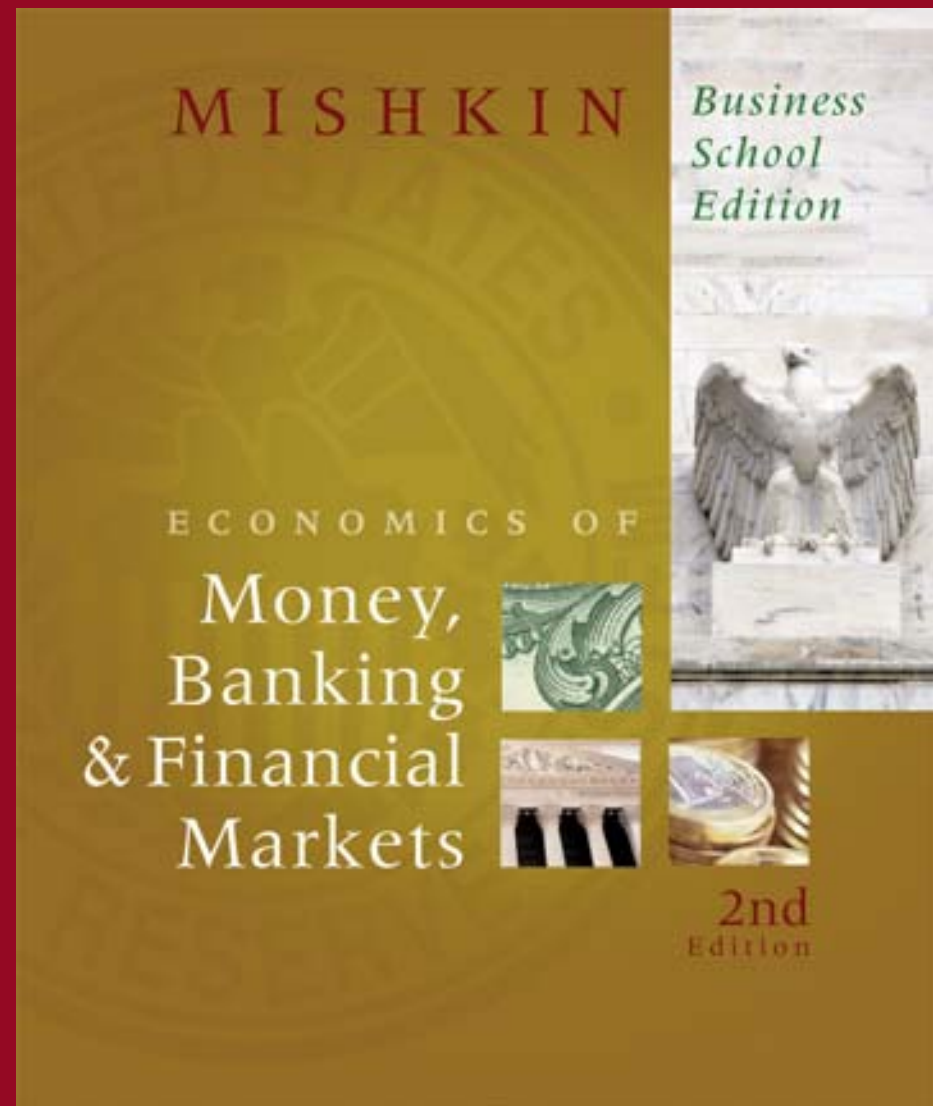


Chapter 2: Part A

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



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

Table 4 Principal Types of Financial Intermediaries & the Values of Their Assets



Type of Intermediary	Value of Assets (\$ billions, end of year)			
	1980	1990	2000	2008
Depository institutions (banks)				
Commercial banks	1,481	3,334	6,469	12,272
Savings and loan associations and mutual savings banks	792	1,365	1,218	1,518
Credit unions	67	215	441	801
Contractual savings institutions				
Life insurance companies	464	1,367	3,136	4,798
Fire and casualty insurance companies	182	533	862	1,337
Pension funds (private)	504	1,629	4,355	5,193
State and local government retirement funds	197	737	2,293	2,730
Investment intermediaries				
Finance companies	205	610	1,140	1,910
* Mutual funds	70	654	4,435	6,588
Money market mutual funds	76	498	1,812	3,376

Source: Federal Reserve Flow of Funds Accounts: www.federalreserve.gov/releases/Z1/.



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