CHAPTER 1: INTRODUCTION TO THE FINANCIAL MARKET AND INSTITUTION

1.0 Objectives of the chapter:

After completing this chapter students should be able to:

- ✓ Understand the financial system in general
- ✓ Describe the types of financial markets and its components
- ✓ Describe the role of financial system
- ✓ Understand the how financial systems are structured
- ✓ Identify the difference between primary and secondary

1.1 Introduction to Financial System

Dear learner, what do you think of financial system?

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Households, corporations, and governments frequently use financial markets to invest excess funds or to borrow funds. A financial market is a market in which financial assets (securities) such as stocks and bonds can be purchased or sold. One party transfers funds in financial markets by purchasing financial assets previously held by another party.

Financial markets play a crucial role in helping individuals, corporations, and government agencies obtain financing. They allow individuals to obtain home mortgages and automobile loans. They allow corporations to obtain long-term financing for expansion, or to obtain short-term financing when experiencing a temporary shortage of funds. They also enable government agencies to borrow funds. Most large expenditures in the economy are financed with funds obtained in financial markets.

Financial markets also play a crucial role in helping individuals or corporations invest in financial assets. They offer alternative investment opportunities for individuals or corporations with excess funds.

1.2 Concept of the Financial System

Dear learner, from previous discussion made, Can you define financial system?

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A financial system is defined as the collection of markets, individuals, laws, polices, systems, conventions, techniques and institutions through which bonds, stocks, and other securities are traded, interest rates are determined and financial services are provided and delivered.

The financial system consists of the group of institutions in the economy that helps to match one person's saving with another person's investment.

The primary task of the financial system is to move scarce loan able funds from those who save to those who borrow to buy goods and services and to make investments so that the economy can grow and increase the standard of living enjoyed by citizens. The end users of this system are people and firms whose desire is to lend and to borrow.

The financial system moves the economy's scarce resources from savers to borrowers.

The financial system determines both the cost of credit and the amount of credit available to pay for the thousands of different goods and services we purchase daily. Equally important, what happens in this system has a powerful impact upon the health of the economy of a nation.

When credit becomes more costly and less available, total spending for goods and services falls.

As a result, unemployment rises and the economy's growth slows down as businesses cut back their production and lay off workers. In contrast, when the cost of credit declines and loan able funds become more available, total spending in the economy often increases, more jobs are created and the economy's growth accelerates.

1.2.1 What is Financial System

Dear learners, Are you clear with the very concept of financial system so far? if so, please say something about it?

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The financing system is necessary to mobilize surplus funds from people and organizations, and to allocate them among deficit people and organizations. An investor (who invests in securities) is an example of a surplus unit, whereas a borrower is an example of a deficit unit. Mobilizing funds generates returns for surplus units, which generally enhances their wealth and economic well-being. It also allows deficit units to enhance their productive and purchasing capacities, and thus improves an economy's production and consumption potential.

Funds are mobilized either as debt or equity. Debt funds are supplied as a loan and generally the repayments are scheduled, whereas equity funds acquire part ownership of a business and their returns depend on the future profitability of the business. The financing process allows prospective users of funds to compete for them and creates the incentive for funds to be supplied. In essence, the financial system should ensure the supply of funds when their use has a net present value. That is, the user of the funds expects to earn a return that exceeds the returns paid to the supplier of the funds.

Financial system: comprises of: borrowers, lenders and financial, intermediaries. This can be split into: individuals, firms, institutions, government agencies, financial instruments, financial services, and financial markets conventions.

Dear learner, Are you with me? Can you guess some problems that need solution from the financing system of the concerned economy?

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There are at least two fundamental problems that must be solved by the financing system. First, deficit units seek funds for terms that, on average, are longer than the periods for which funds are supplied by surplus units, posing the problem of a maturity mismatch between the supply and demand for funds. This means that financing processes have to be able to transform the maturity of funds - a process referred to as maturity transformation. Second, financing processes have to develop means for coping with the risks faced by the suppliers of funds.

The financing process requires the comprehensive disclosure of relevant information to allow investors and other suppliers of funds to assess the risks and expected returns associated with the proposed use of funds.

Helping funds to flow from lenders to borrowers is a characteristic of most components of the financial system. However, there are a number of functions, each of which tends to be associated with a particular part of the system. For example, the financial system usually provides a means of making payments. In most cases this is the responsibility of deposit taking institutions (or a subset of them). Such institutions are usually members of a network (a clearing system) and accept instructions from their clients to make transfers of deposits to the accounts of clients. Traditionally, this was done by issuing a paper instruction (a check) but today it is done increasingly by electronic means.

We assume most people are risk-averse. That is, most people are prepared to make a payment (or sacrifice some income) in order to avoid uncertainty, especially if the uncertainty mean possibility of a serious loss. Amongst the non-deposit taking institutions this service is carried out by insurance companies. They allow people to choose the certainty of a slightly reduced current income (reduced by the premiums they pay) in exchange for avoiding a catastrophic loss of income (or wealth) if some accident should occur.

Pension funds, unit trusts and investment trusts all offer savers the opportunity to accumulate a diversified portfolio of financial assets, though each does it in a slightly different way. Pension funds in particular help people to accumulate wealth over a long period and then to exchange this for income to cover the (uncertain) period between retirement and death.

Lastly, it should always be remembered that while savers may be building up a portfolio of wealth by acquiring financial assets, they want to be able to rearrange that portfolio from time to time as they observe changes in the risk/return characteristics of the assets which they hold. If we use the phrase net acquisition to describe the additional assets that a household is able to add to its portfolio each year, we must remember that total purchase of assets may be much larger because there may also have been sales of some assets already in the portfolio as part of the portfolio adjustment process.

1.1 Check Your Progress

1-What is financial system?

2- Who are the participants in financial system?

1.2.2 Financial Market

Dear learner, from the previous discussion made on financial system, can you define financial market?

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A financial market is a market in which financial assets are traded. In addition to enabling exchange of previously issued financial assets, financial markets facilitate borrowing and lending by facilitating the sale by newly issued financial assets. Examples of financial markets include the New York Stock Exchange (resale of previously issued stock shares), the U.S. government bond market (resale of previously issued bonds), and the U.S. Treasury bills auction (sales of newly issued T-bills).

A financial institution is an institution whose primary source of profits is through financial asset transactions. Examples of such financial institutions include discount brokers (e.g., Charles Schwab and Associates), banks, insurance companies, and complex multi-function financial institutions such as Merrill Lynch.

A financial market is a market in which trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds, and commodities include precious metals or agricultural goods.

There are both general markets (where many commodities are traded) and specialized markets (where only one commodity is traded). Markets work by placing many interested buyers and sellers, including households, firms, and government agencies, in one "place", thus making it easier for them to find each other. An economy which relies primarily on interactions between buyers and sellers to allocate resources is known as a market economy in contrast either to a command economy or to a non-market economy such as a gift economy.

In finance, financial markets facilitate:

- ✓ The raising of capital (in the capital markets)
- ✓ The transfer of risk (in the derivatives markets)
- ✓ Price discovery
- ✓ Global transactions with integration of financial markets
- ✓ The transfer of liquidity (in the money markets)
- ✓ International trade (in the currency markets) and are used to match those who want capital to those who have it.

Typically a borrower issues a receipt to the lender promising to pay back the capital. These receipts are securities which may be freely bought or sold. In return for lending money to the borrower, the lender will expect some compensation in the form of interest or dividends. This return on investment is a necessary part of markets to ensure that funds are supplied to them.

1.3 Structure of Financial System

Dear learner, what do you think the financial system looks like?

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The financial system is complex, comprising many different types of private sector financial institutions, including banks, insurance companies, mutual funds, finance companies, and investment banks, all of which are heavily regulated by the government.

If an individual wanted to make a loan to IBM or General Motors, for example, he or she would not go directly to the president of the company and offer a loan. Instead, he or she would lend to such companies indirectly through financial intermediaries, institutions that borrow funds from people who have saved and in turn make loans to others. Why are financial intermediaries so crucial to well-functioning financial markets? Why do they extend credit to one party but not to another? Why do they usually write complicated legal documents when they extend loans? Why are they the most heavily regulated businesses in the economy?

1.3.1 The organization of markets

Dear learner, what do you think markets refers to you?

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A Market is institutional mechanism where supply and demand meet to exchange goods and services; or a place or event at which people gather in order to buy and sell things in order to trade. Exciting with many different functions, the financial system fulfills its various roles mainly through markets where financial claims and financial services are traded (though in some least-developed economies Government dictation and even barter are used). These markets may be viewed as channels through which moves a vast flow of loan able funds that it continually being drawn upon by demanders of funds and continually being replenished by suppliers of funds. Filled with a desire to lend or to borrow, the end users of most financial systems are faced with a choice between three broad approaches:

- √ Firstly, they may decide to deal directly with another, which is costly, risky, inefficient, consequently; and not very likely.
- √ More typically, they may decide to use one or more of many organized markets. In these markets, lenders buy the liabilities issued by the borrowers. If the liability is newly issued, then the issuer receives funds directly from the lender. More frequently, however, a lender will buy an existing liability from another lender. In effect, this refinances the original loan though the borrower who is completely unaware of this secondary transaction.

Alternatively, borrowers and lenders may decide to deal via intermediaries. In this case, lenders have an asset – a bank deposit or contribution to a life insurance or pension fund – which can not be traded but can only be returned to the intermediary. Similarly, intermediaries create liabilities, typically in the form of loans, for borrowers. These remain in the intermediaries balance sheets until they are repaid. Intermediaries themselves will also make use of markets, issuing security to finance some of their activities and buying shares and bonds as part of their asset portfolio.

Hi Guys! Are you doing well? Don't forget that by now you have already acquired the basic knowledge of the matter we are dealing with. This by itself is a great success. To conclude your effort with joy, as usual try to use your time wisely and economically. Do the work today, and enjoy your time with fruitful result. I wish you all the best!

1.3.2 The role of markets in an economy

Dear learner, can you list the role of market in the economy?

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The financial markets perform a vital function within the economic system. The financial markets channel savings which come mainly from households to those individuals and institutions who need more money (funds) for spending than are provided by current income. It is known that the basic function of any economy is to allocate scarce resources in order to produce the goods and services needed by society.

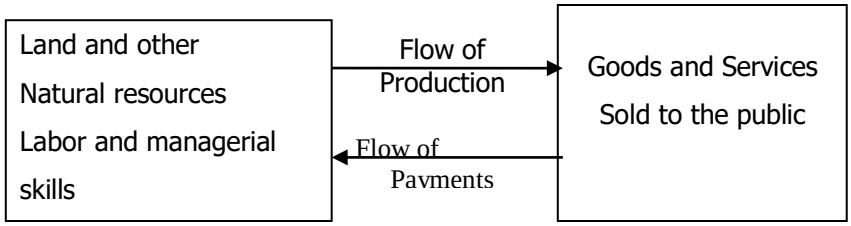


Figure 1: Circular flow production and payment

Source: Kidwell, D. 2003/Modified

The diagram shows that the system is just a circular flow between producing units (mainly business and government) and consuming units (mainly households). In modern economies, households provide labor, management skills, and natural resources to business firms and governments in return for income in the form of wages, rents and dividends. Therefore, one can see that markets are used to carry out the task of allocating resources which are scarce relative to the demand of the society. Here we are referring the markets which are different from the financial markets; the goods market and the factor markets.

1.3.3 The Structure of Markets

It is known that the basic function of any economy is to allocate scarce resources in order to produce the goods and services needed by society. In modern economies, households provide labor, management skills, and natural resources to business firms and governments in return for income in

the form of wages, rents and dividends. Consequently, one can see that markets are used to carry out the task of allocating resources which are scarce relative to the demand of the society. Here we are referring the markets which are different from the financial markets, the goods market and the factor markets. Therefore, we can see that there are essentially three types of markets at work within the economic system. *These are:* - Factor markets; product market; and financial markets.

a) ***Factor markets:*** **-** are markets where consuming units sell their labor, management skill, and other resources to those producing units offering the highest prices. i.e. this market allocates factors of production (Land, labor and capital – and distribute incomes in the form of wages, rental income and so on to the owners of productive resources.

b) ***Product market:*** **-** are markets where consuming units use most of their income from the factor markets to purchase goods and services i.e. this market includes the trading of all goods and services that the economy produces at a particular point in time.

c) ***Financial markets:*** **-** There are markets in which flow of funds, flow of financial services, income and financial claims is affected i.e. essentially; financial markets do have three main tasks. *These are:*

1. They determine the nature of credit available at a macroeconomic level;
2. They attract savers and borrowers; and
3. They set interest rate and security prices.

The role of markets in an economic system is carrying out a task of allocating resources and predicting goods and services.

d)That is allocating resources which are scarce relative to the demand of society one can see that the market place determines what goods and services will be produced and in what quantity. This is accomplished essentially through changes in the prices of commodities and services offered in the market. In addition, it is easy to understand that markets also distribute income. In a pure market system, the income of an individual or business firm is determined solely by the contributions each makes to production. Markets provide superior productivity, innovation and sensitivity to consumer needs with increased profits, higher wages and other economic benefits.

Dear learner, so can you list the types of market in the economy and identify which market is our area of interest in this course?

What Types of Financial Market Structures Exist?

Dear learner, can you guess the types of financial market available?

The costs of collecting and aggregating information determine to a large extent, the types of financial market structures that emerge. These structures take four basic forms; namely: Auction Markets; Over-the-counter markets; Organized Exchanges; and Intermediation Financial Markets.

i. Auction Markets

An auction market is some form of centralized facility (or clearing house) by which buyers and sellers, through their commissioned agents (brokers), execute trades in an open and competitive bidding process. The "centralized facility" is not necessarily a place where buyers and sellers physically meet. Rather, it is any institution that provides buyers and sellers with a centralized access to the bidding process. All of the needed information about offers to buy (bid prices) and offers to sell (asked prices) is centralized in one location which is readily accessible to all would-be buyers and sellers, e.g., through a computer network.

No private exchanges between individual buyers and sellers are made outside of the centralized facility.

An auction market is typically a public market in the sense that it open to all agents who wish to participate. Auction markets can either be call markets -- such as art auctions -- for which bid and asked prices are all posted at one time, or continuous markets -- such as stock exchanges and real estate markets -- for which bid and asked prices can be posted at any time the market is open and exchanges take place on a continual basis. Experimental economists have devoted a tremendous amount of attention in recent years to auction markets.

Many auction markets can trade in relatively homogeneous assets (e.g. treasury bills, notes, and bonds) to cut down on information costs. Alternatively, some auction markets (e.g., in second-hand

jewelry, furniture, paintings etc.) allow would-be buyers to inspect the goods to be sold prior to the opening of the actual bidding process.

This inspection can take the form of a warehouse tour, a catalog issued with pictures and descriptions of items to be sold, or (in televised auctions) a time during which assets are simply displayed one by one to viewers prior to bidding.

Auction markets depend on participation for any one type of asset not being too "thin." The costs of collecting information about any one type of asset are sunk costs independent of the volume of trading in that asset. Consequently, auction markets depend on volume to spread these costs over a wide number of participants.

ii. Over-the-counter markets:

An over-the-counter market has no centralized mechanism or facility for trading. Instead, the market is a public market consisting of a number of dealers spread across a region, a country, or indeed the world, who make the market in some type of asset. That is, the dealers themselves post bid and asked prices for this asset and then stand ready to buy or sell units of this asset with anyone who chooses to trade at these posted prices. The dealers provide customers more flexibility in trading than brokers, because dealers can offset imbalances in the demand and supply of assets by trading out of their own accounts. Many well-known common stocks are traded over-the-counter through NASDAQ (National Association of Securities Dealers' Automated Quotation System).

iii. Organized Exchanges

The financial markets, such as the New York Stock Exchange, which combines auction and OTC market features, are called Organized Exchanges. Specifically, organized exchanges permit buyers and sellers to trade with each other in a centralized location, like an auction. However, securities are traded on the floor of the exchange with the help of specialist traders who combine broker and dealer functions. The specialists broker trades but also stand ready to buy and sell stocks from personal inventories if buy and sell orders do not match up.

iv. Intermediation Financial Markets:

An intermediation financial market is a financial market in which financial intermediaries help transfer funds from savers to borrowers by issuing certain types of financial assets to savers and receiving other types of financial assets from borrowers. The financial assets issued to savers are claims against the financial intermediaries, hence liabilities of the financial intermediaries, whereas the financial assets received from borrowers are claims against the borrowers, hence assets of the financial intermediaries.

1.2 Check your progress

1- What is the difference between financial system and financial market?
2- Describe auction market in short?
3- What is the role of financial market in brief?
4- What are financial intermediaries?

1.4 Functions of financial system (market)

Dear learner, can you list some of the important functions of financial system?

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The following are the major functions of financial system:

1. Borrowing and Lending

One key function of financial markets is to facilitate the financing of new borrowing. Financial markets bring savers (agents with excess funds relative to their desired expenditures) together with would-be borrowers (agents who are short of funds relative to their desired expenditures). The borrowers issue new liabilities against themselves in return for receiving the excess funds of savers.

In general, there is a mismatch of income and spending needs between households and businesses in an economy that creates an opportunity for borrowing and lending. In the aggregate, the household sector tends to have on hand more funds than it currently wishes to consume (i.e., savings), and the business sector tends to have fewer funds on hand than it wishes to invest. Financial markets provide a mechanism by which the household sector can lend its savings to the business sector for investment purposes.

SAVINGS INVESTMENT

HOUSEHOLD ---------> BUSINESS ----------> PROJECTS

SECTOR SECTOR

***Figure** 2: Borrowing and Lending*

There are two central mechanisms for the transfer of funds from savers to borrowers to facilitate new acts of borrowing: indirect finance; and direct finance.

Indirect Finance:

Funds are channeled *indirectly* from savers to borrowers in intermediation financial markets by means of financial intermediaries (FIs). The FIs engage in asset transformation; they acquire financial assets newly issued by borrowers (e.g., residential mortgages), which the FIs pay for (fund) by issuing to savers financial assets newly issued by themselves (e.g., deposit accounts). Consequently, the FIs hold claims against the ultimate borrowers whereas the savers hold claims only against the FIs.

Indirect Finance Examples: A bank XYZ provides loaned funds to a household under the terms of a residential mortgage loan contract (held by XYZ as a claim against the household) using monies collected from its depositors (i.e., holders of XYZ deposit account contracts); A defined-contribution pension fund HIRSK buys commercial paper newly issued by a corporation, paid for using the contributions collected from the participants in HIRSK.

Direct Finance:

Savers *directly* finance new acts of borrowing by purchasing newly issued financial assets in the same form as originally issued by borrowers (no asset transformation). Consequently, the savers directly hold claims against these borrowers.

Direct Finance Examples: A corporation directly buys newly issued commercial paper from another corporation; A household buys a newly issued government bond through the services of a broker (no asset transformation).

Important Note: Transactions involving the purchase of *existing* financial assets (e.g., households purchasing corporate stock shares from other households) do not involve any new borrowing. Such transactions simply reallocate among savers the existing volume of claims against borrowers without creating any new claims in net terms. Consequently, given any particular purchase of a financial asset, it can represent an instance of indirect finance, direct finance, *or neither*.

As pointed out by Mishkin,2004, studies show that firms in major developed countries have traditionally relied more on indirect than on direct financing to obtain their borrowed funds. The reasons for this will be explored in later parts of the course.

2. Price Determination

Intermediation Financial Markets:

Financial intermediaries pool the funds of many small savers to lend money to individual borrowers. Interest is paid to savers in exchange for use of their funds for lending, while borrowers pay interest on their loans.

The difference between the rate paid by borrowers and the (generally lower) rate paid to savers can be considered a "price" for the services provided by the financial intermediary to both the borrower and lender.

The goal of intermediaries is generally to borrow funds from savers at low rates and to lend funds to borrowers at high rates -- "borrow low, lend high."

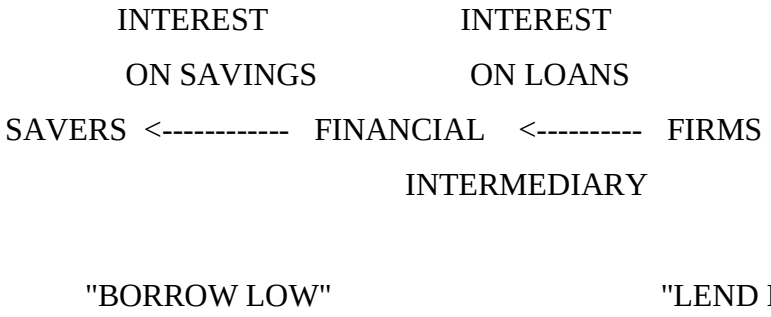


Figure 3: *Intermediation*

Auction Securities Markets:

In auction markets, brokers receive bid and asked prices from buyers and sellers and facilitate exchange by matching received bid prices with received asked prices of equal or lesser value so that exchanges can take place. In some cases, only bids are received (so that effective asked prices are zero) and items are simply sold to the highest bidders.

Example*: Treasury Auctions*

For example the U.S. Government regularly auctions newly issued Treasury bills, notes, and bonds ("treasuries") to finance the Federal government debt. Most newly issued treasuries are bought by "primary dealers" -- financial institutions that are active in buying and selling U.S. government securities and that have established business relations with the New York Fed. A much smaller volume of newly issued securities is purchased by individual investors who buy them directly from the Treasury Department at auction instead of in a secondary (resale) market.

A modern auction process for bills, notes, and bonds begins with a public announcement by the Treasury: e.g., "The Treasury will auction $11,000 million of 91 day bills to refund $9,000 million of maturing securities and to raise about $2,000 million in new cash."

Bids are then accepted for up to thirty days in advance of the auction. All bids are confidential and are kept sealed until the auction date. Two types of bids can be submitted: non-competitive tenders (usually submitted by small investors and individuals) submitted in dollar amounts (e.g., $1 million); and competitive bids (usually submitted by primary dealers for their own accounts) submitted in terms of both desired unit price (equivalently, yield to maturity or discount rate) and desired dollar amounts.

On the day of the auction, officials at the Treasury Department first subtract from the public securities offering the total dollar amount of securities bid by non-competitive bidders (who automatically receive securities) in order to determine the total dollar amount of securities available to competitive bidders. For example, if $1 billion in non-competitive tenders is received in an $11 billion public offering of securities, $1 billion in securities will be awarded to non-competitive bidders and $10 billion in securities will be awarded to competitive bidders.

The Treasury officials then work their way down the list of competitively bid unit prices, starting with the highest, accepting the dollar-amount bids for securities submitted with these prices until all securities available for competitive bidders (e.g., $10 billion) have been awarded. Any remaining competitive bids are then rejected. For 2-year and 5-year notes, a single-price auction scheme is used to set the actual price of each security: specifically, all non-competitive bidders and all accepted competitive bidders are awarded their dollar-amount bids at a uniform unit price equal to the unit price bid by the marginal (last) accepted competitive bidder.

Over-the-Counter Securities Markets:

In over-the-counter securities markets (e.g., Nasdaq), dealers make the market for particular types of securities (e.g., stocks) by posting their own bid prices (offers to buy) and asked prices (offers to sell) for units of the security. The difference between any particular dealer's asked price and bid price for units of a security -- called the dealer's *bid-asked spread* -- constitutes the dealer's anticipated gross profit margin on trades in this security. For obvious reasons, bid-asked spreads are always positive. An individual (or institution) wishing to buy or sell a security in an over-the-counter market generally makes use of a broker. The broker seeks out the best available bid or asked price posted by the dealers making a market in this security and then executes the individual's desired trade.

3. Information Aggregation and Coordination

Intermediation Financial Markets:

It is difficult to get information about the credit worthiness of individuals or small businesses, as well as to seek out potential borrowers or lenders.

The specialized information gathering resources and skills of financial intermediaries help to reduce the costs of acquiring information about potential borrowers and lenders. In addition, financial intermediaries act as a coordination device by providing a centralized facility to which would-be lenders and borrowers can direct their demands and supplies for funds.

Securities Markets:

Financial assets sold in securities markets (i.e., in auction markets, over-the-counter markets, or organized exchanges) are financial assets that have been transformed into relatively liquid

marketable assets by means of various legally enforceable guarantees provided either by the original issuer of the asset or by other parties.

Many investment advisory firms provide publicly attainable ratings for securities based on the perceived trustworthiness of these guarantees. For example, Moody's Investors Service and the Standard and Poor's Corporation provide default risk information by rating the quality of corporate and municipal bonds, and Merrill Lynch continually announces buy and sell recommendations for various stocks. These ratings reduce the need for participants in securities markets to acquire detailed information, themselves, about the original issuers of the assets.

4. Risk Sharing

Risk refers to the degree of uncertainty concerning an asset's return.

Risk Diversification:

Financial markets permit savers to diversify their asset portfolios by purchasing financial assets from many different borrowers who face separate types of risks.

In this way, even if some assets in the portfolio generate low rates of return, these low rates may be offset by high rates of return earned by other assets in the portfolio.

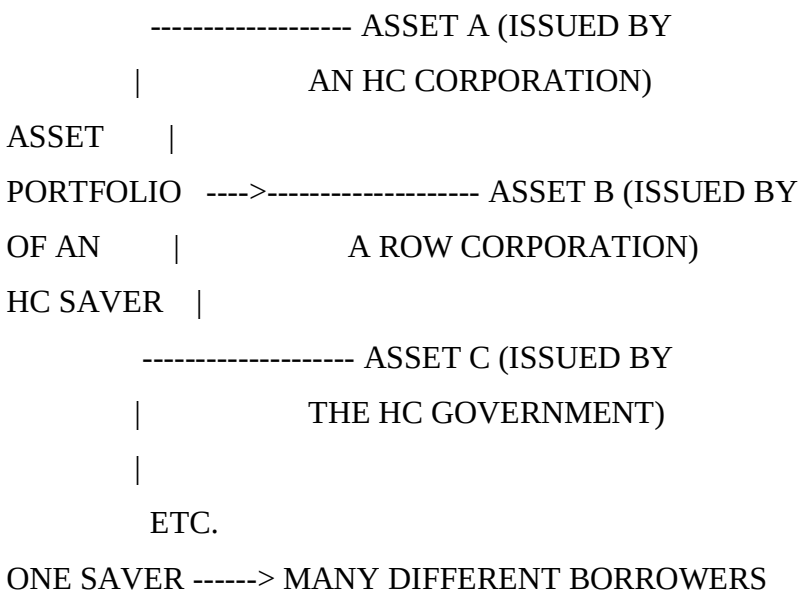


Figure 4: Risk Diversification

Risk Pooling:

Conversely, financial markets permit borrowers to transfer their risk to lenders by issuing financial assets to a pool of savers that then collectively shares the risk (e.g., default) burden.

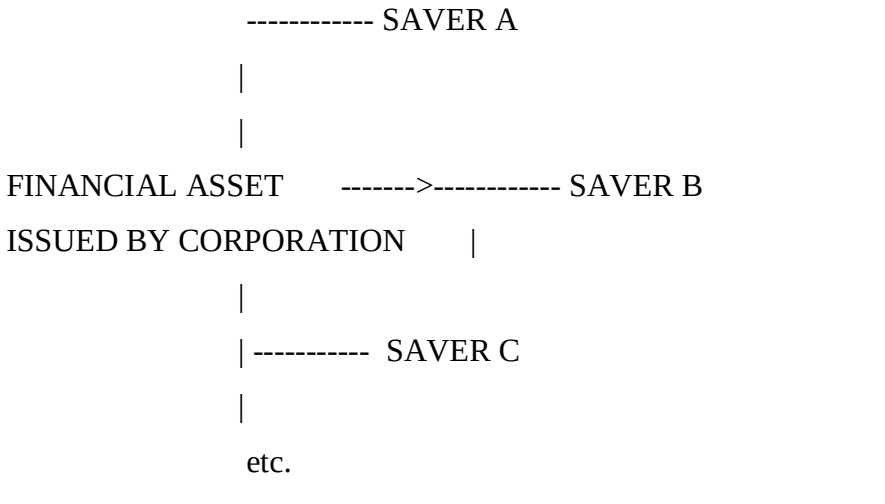


Figure 5: Risk Polling

5. Liquidity

The liquidity of an asset refers to the ease with which that asset can be converted into a means of payment for goods and services.

Securities markets enhance the opportunity for savers to save their assets in relatively liquid form while still generating a stream of returns. If a saver were to lend to a personal acquaintance rather than lending through a securities market, he or she would typically lose out on the liquidity offered by lending through a securities market because personal loan agreements are generally not liquid. That is, it would generally be difficult to sell such a loan contract to a third party in return for cash in advance of the maturity of the loan.

6. Efficiency

Financial markets reduce transactions and information costs.

Securities markets provide centralized or decentralized means for individual savers to purchase financial assets from borrowers. Since the financial assets sold in securities markets are subject to general legal restrictions (e.g., information disclosure laws), individual savers do not need to engage, themselves, in the design and enforcement of contracts with individual borrowers.

The manner in which transactions and information costs are reduced in intermediation financial markets is more complicated, involving a consideration of asymmetric information, monitoring, and enforcement. These issues are introduced in preliminary fashion below and taken up in much greater detail in later parts of the course.

1.5 Goal of Financial System

Dear learner, what do you think is the major goal of financial system?

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A. Goal One

The first goal of the financial system (FS) is to facilitate the flow of funds from savers (entities with a surplus of funds) to investors (entities with a deficit of funds).

Dear learners! Before going any further, so as to be familiar with the concept of this facilitation role let us first distinguish the distinction between real assets and financial assets.

A real asset is an entity that generates a flow of goods or services over time.

- √ Examples include land, people, factories, inventions, business plans, and goodwill with consumer's reputation.

Key point: real assets need not be tangible.

A financial asset is a legal contract that gives its owner a claim to payments, usually generated by a real asset.

- √ Examples include currency ($), stocks, bonds, bank deposit, bank loans, options, futures, etc.

Ultimate investors sell financial assets to savers; they use the proceeds to buy real assets (buying real assets is the same thing as investment). Sometimes people sell financial assets to finance consumption too. Given this first role, the FS is the place where savers (or, more generally, economic agents with a surplus of funds relative to their immediate need for those funds) meet investors (or, more generally, economic agents with a deficit of funds relative to their immediate need for those funds).

The financial system channels funds from savers to investors. Agents can invest using their own funds, using indirect finance, or using direct finance. When agents invest out of their own funds (i.e. by spending past accumulated savings), they bypass the FS entirely (although they usually use the FS while savings are accumulated). When agents use indirect finance, funds come from a financial intermediary, which are then invested (or spent on consumption goods). A financial intermediary is a firm that pools the savings of many agents and then passes those funds through to agents that want to invest them. The intermediary is the middleman, not the ultimate source of funds. An agent can uses direct finance, so that funds are provided to the investors directly, without the use of an intermediary.

B. Goal Two

The second goal of the FS is to allow economic agents to share risks. There are many risks that have very high costs but low likelihood of occurring such as hurricanes, early death, failure of a business etc. Risk averse people prefer to share these risks rather than bear them alone.

Dear learners? How does the financial system allow agents to share these risks?

Financial Institutions specialize in assessing and managing risk. Thus, many firms will delegate this function to those institutions. An obvious example is the insurance industry. A less obvious example from banking is the letter of credit. A letter of credit is a promise by the issuer (the bank) to make good on behalf of the beneficiary (the party paying a fee to the bank) if that beneficiary fails to perform. Commercial letters of credit are commonly used to remove the risks of non-payment in import/export industries. Standby letters of credit are used to shift risk to the bank in other business contexts.

- ✓ Example: commercial paper standby letters of credit allow relatively risky companies to issue these highly liquid, short-term debt obligations that otherwise would not be able to access this market.

Another way that Financial Institutions use risk management techniques to enhance liquidity is through credit enhancement. A simple example of credit enhancement: e.g. a parent's co-signing their children's credit card. Financial Institutions must maintain good reputation for high credit quality to play this role. Both financial and reputational capitals are valuable assets for risk

management function, just as they are in information production and dissemination. In addition, Financial Institutions must know how to manage the risks that they assume efficiently. Life insurance companies must understand mortality risks, banks must understand the risks that borrowers will fail to pay, and so on.

C. Goal Three

The third main goal of the financial system is to generate liquidity. An asset is liquid if it can be converted into cash quickly with little or no loss in value. In other words an asset must be considered liquid if its price tends to be reasonably stable overtime, if it has an active resale market, and if it is reversible so that investors can recover their original investment without loss.

There are two notions of liquidity, both of which are important. The market liquidity of an asset (real or financial) is the ease with which it may be traded. Here are the key characteristics of liquid assets: Standardized; Value is well understood by all; Many potential buyers and sellers

Intermediaries such as brokers and dealers enhance market liquidity.

The second notion of liquidity, funding liquidity, is the ability of an entity to come up with cash on short notice. For example, a firm holding cash on its balance sheet, or a person with cash in their wallet, has a high degree of funding liquidity. Firms and households need funding liquidity to have the option to make investments on short notice. The financial system supplies this liquidity with currency (government supplied), demand deposits (supplied by banks) & lines of credit (also mainly supplied by banks).

The concept of risk-sharing and liquidity creation are closely linked. As we saw, asymmetric information is a key barrier to liquidity. One way that financial institutions create liquid financial assets is by splitting a financial asset into two: one that concentrates all of the risk and remains illiquid, and the other that is relatively safe and therefore liquid. Because liquidity is so valuable, this process adds value and can therefore be profitable. Liquid assets are more valuable than illiquid assets. Hence, if financial institutions can buy a financial asset and increase the liquidity of the assets, they have made a profit.

Where does liquidity come from?

Information is the key component for creating liquidity of a financial asset. If the owner of a financial asset knows more about its value than anyone else, they will have trouble selling that asset at a fair price. Financial System can enhance liquidity by disseminating information to potential buyers. There are mandatory cases where financial institutions disseminate information to enhance liquidity:

What makes dissemination of believable information possible?

Reputation capital: Future profits that would be lost if the firm provides bad information.

Financial capital: Current accumulated profits that would be lost.

Private regulation: e.g. Public Accounting Firms (who have substantial capital...) *Government regulation*: The Security Exchange Commission (SEC) enforces rules regarding disclosure.

1.5 Primary versus Secondary Markets

Dear learner, what do you understand by primary vs secondary markets?

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_____

The global financial markets may also be divided into primary markets and secondary markets. Primary Market, also called the new issue market, is the market for issuing new securities. Many companies, especially small and medium scale, enter the primary market to raise money from the public to expand their businesses. They sell their securities to the public through an initial public offering. The securities can be directly bought from the shareholders, which is not the case for the secondary market.

The primary market is a market for new capitals that will be traded over a longer period.

Primary markets are securities markets in which newly issued securities are offered for sale to buyers. Secondary markets are securities markets in which existing securities that have previously been issued are resold. The initial issuer raises funds only through the primary market. Primary market transactions provide funds to the initial issuer of securities; secondary market transactions do not. Some securities have a more active secondary market and are therefore snore marketable than others. This is an important feature for financial market participants if they plan to sell security holdings prior to maturity The issuance of new corporate stock or new Treasury securities

represents a primary market transaction, while the sale of existing corporate stock or Treasury security holdings by any businesses or individuals represents a secondary market transaction.

In the primary market, securities are issued on an exchange basis. The underwriters, that is, the investment banks, play an important role in this market: they set the initial price range for a particular share and then supervise the selling of that share. Investors can obtain news of upcoming shares only on the primary market. The issuing firm collects money, which is then used to finance its operations or expand business, by selling its shares. Before selling a security on the primary market, the firm must fulfill all the requirements regarding the exchange. After trading in the primary market the security will then enter the secondary market, where numerous trades happen every day.

The primary market accelerates the process of capital formation in a country's economy. The primary market excludes several other new long-term finance sources, such as loans from financial institutions. Many companies have entered the primary market to earn profit by converting its capital, which is basically a private capital, into a public one, releasing securities to the public. This phenomena is known as "public issue" or "going public." There are three methods through which securities can be issued on the primary market. These are**:** Rights issue; Initial Public Offer (IPO); and Preferential issue.

A company's new offering is placed on the primary market through an initial public offer.

Firms raise new capital in a primary market transaction by issuing new securities (stocks or bonds) once, and these securities subsequently trade in the secondary market forever. Initial public offering (IPO) is stock issued for the very first time to the public when a company "goes public." The holders of these stocks can have the following rights:

Preemptive rights - on issuance of additional share allows existing investors to maintain their ownership position (as a percentage) when new stock is issued. Without this right investors would have their ownership interest diluted.

Rights of offering - allow existing stockholders to buy additional shares in the company at a subscription price that is generally lower than the market price. Rational stock holders will either exercise the right or sell it (those who let it expire will find out that the market value of their remaining holding shrinks-the market price will almost certainly drop when the rights are exercised since the subscription price is much lower than the market price.

1.3 Check your Progress

1- List the basic functions of financial system?

2- How does financial system play the role of risk sharing?

3- What makes dissemination of believable information possible?

4-Write the difference between primary and secondary market?

1.6. Summary

Households, corporations, and governments frequently use financial markets to invest excess funds or to borrow funds. A financial market is a market in which financial assets (securities) such as stocks and bonds can be purchased or sold. One party transfers funds in financial markets by purchasing financial assets previously held by another party.

A financial system is the collection of markets, individuals, laws, polices, systems, conventions, techniques and institutions through which bonds, stocks, and other securities are traded, interest rates are determined and financial services are provided and delivered. The financial system consists of the group of institutions in the economy that helps to match one person's saving with another person's investment. The primary task of the financial system is to move scarce loan able funds from those who save to those who borrow to buy goods and services and to make investments so that the economy can grow and increase the standard of living enjoyed by citizens. The end users of this system are people and firms whose desire is to lend and to borrow.

The costs of collecting and aggregating information determine to a large extent, the types of financial market structures that emerge. These structures take four basic forms; namely: Auction Markets; Over-the-counter markets; Organized Exchanges; and Intermediation Financial Markets.

Self Assessment Questions 1

Part I-Multiple Question: Chose the best answer among the alternative given below each questions.

1-Which of the following is not the function/s of financial system?

A- Borrowing and Lending

B- Information Aggregation and Coordination

C- Risk Sharing

D-Financial markets reduce transactions and information costs.

E- None

2-_____ is the collection of markets, individuals, and laws, polices, systems, conventions, techniques and institutions through which bonds, stocks, and other securities are traded, interest rates are determined and financial services are provided and delivered.

A-Financial Market B) Financial System C) Financial Institutions D) None

3-_____ is some form of centralized facility (or clearing house) by which buyers and sellers, through their commissioned agents (brokers), execute trades in an open and competitive bidding process.

A) Auction Market B) Over the counter market

C) Financial Intermediary D) None

4-All are true about primary market and secondary market except?

A- Primary market is a market for new capitals.

B-Secondary markets are securities markets in which newly issued securities are offered for sale to buyers.

C- Secondary markets are securities markets in which existing securities that have previously been issued are resold.

D) In primary market securities can be directly bought from the shareholders, which is not the case for the secondary market.

E) B and D

5- _____is a market in which trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand.

A-Financial Market B) Financial System C) Financial Institutions D) None

Part II- True or False: Write true if the statement is correct and false if it is not correct.

1-A financial institution is an institution whose primary source of profits is through financial asset transactions.

2-Funds are channeled indirectly from savers to borrowers in intermediation financial markets by means of auction market.

3-The primary task of the financial system is to move scarce loan able funds from those who save to those who borrow to buy goods and services .

4-An over-the-counter market has no centralized mechanism or facility for trading.

5-In over-the-counter securities markets (e.g., Nasdaq), dealers make the market for particular types of securities (e.g., stocks) by posting their own bid prices (offers to buy) and asked prices (offers to sell) for units of the security.

CHAPTER TWO: FINANCIAL INTERMEDIATION

2.0. Objectives:

After studying this chapter you should be able to:

- ✓ Understand financial intermediaries
- ✓ Describe the role of financial intermediaries in the economy.
- ✓ Explain the various types of financial intermediaries.
- ✓ Understand the financial market instruments available in the economy.

2.1 Concept of Financial Intermediaries

Dear learner, welcome to the second chapter, from the previous chapter, I hope you have a good understanding about financial intermediaries. Thus, what is a financial intermediary?

Financial intermediation consists of "channeling funds between surplus and deficit agents''. A financial intermediary is an entity that connects surplus and deficit agents. The classic example of a financial intermediary is a bank that transforms bank deposits into bank loans. As such, financial intermediaries channel funds from people who have extra money (savers) to those who do not have enough money to carry out a desired activity (borrowers).

To have a clear understanding about financial intermediaries let we see the following:

Surplus units: Economic agents for whom receipts are higher than expenditures are called surplus units, savers, or ultimate lenders. Let these units earn Ys (income) and consume Cs. Then their saving, Ss is equal to Ys - Cs. Now, some of these savings are invested (Is) and the rest remain as surplus, i.e.,

Ss = Is + surplus.

Deficit units: Those who spend in excess of what they receive are called deficit units, dissavers, or ultimate borrowers. The savings of the deficit units is:

Yd - Cd = Sd. Now, deficit units invest more than they save.

Therefore, Sd + deficit = Id.

For the economy as a whole,

Ss + Sd + deficit = Is + Id + surplus

Now, in a closed economy, the surplus and deficit cancel out, since they equal each other. Therefore, we are left with Ss + Sd = Is + Id, or S = I

On one side we've common men (households), these folks spend money and save money. So these are the people who have "surplus" money (Surplus unit). On the opposite side, we've businessmen (industries) who provide goods and services. They need money to start new business, to expand existing business, sometimes Government also needs money (Deficit Units). So these are the people that "want" money. Financial intermediaries are the middlemen between these two types of people. Banks, insurance companies, pension funds, mutual funds etc. are the examples of financial intermediaries. They take money from the savers (or lenders) and loan it directly or indirectly to the borrowers (Government / businessmen).

Borrower (Government / Businessman) pays the interest rate on this loan. The intermediary (bank/insurance co./pension or mutual fund), will get Commission. And the Common men will earn some profit / interest / dividend/ return on his investment.

Thus, financial intermediaries in short are;

- ✓ The institutions that channel funds from savers to users are called financial intermediaries.
- ✓ Institutions that channel funds between surplus and deficit agents are called financial intermediaries.
- ✓ Financial intermediaries serve as a middleman between saver and borrower.

What do the households do with their surplus, and how do corporations and governments finance their deficits?

-Financial instruments are created to evidence the transfer of funds from one sector to the other. These are financial claims. These can be in the form of notes, bills, bonds, debentures, shares, etc.

-To the household the financial claim constitutes a financial asset. To the corporation/ govt. the claim consists of a financial liability.

We see that:

Surplus = net lending = change in net financial assets

= change in net credit

Deficit = net borrowing = change in net financial liabilities

= change in net debt

2.1 Check Your Progress

1- Explain financial intermediaries?

2- Who are the surplus units, give example?

3- Who are the deficit unit, give example?

2.2 Function of Financial Intermediaries (Institutions) (FI)

Dear learner, from the previous discussion made on financial intermediaries, Can you list some of the basic functions of financial intermediaries?

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_____

As mentioned above, the process of indirect finance using financial intermediaries, called financial intermediation, is the primary route for moving funds from lenders to borrowers. Indeed, although the media focus much of their attention on securities markets, particularly the stock market, financial intermediaries are a far more important source of financing for corporations than securities markets are. Why are financial intermediaries and indirect finance so important in financial markets? They are important since they are basis for mitigating or reducing the following problems:

1-Monitoring costs would be very high for individuals making loans or supplying capital directly to borrowers e.g. companies or other individuals, vs. financial intermediaries.

2-Financial claims like private loans might be very illiquid, and there might be very high transaction costs for trading the financial claims. Transaction cost, the time and money spent in carrying out financial transactions, are a major problem for people who have excess funds to lend.

Transaction costs = the time and money spent in carrying out financial transactions.

Financial intermediaries help to reduce transaction costs by taking advantage of economies of scale. Example: a bank can use the same loan contract again and again, thereby reducing the costs of making each individual loan.

3-Individuals would be exposed to a high level of risk, undiversified investment portfolios. Risk is uncertainty about the returns investors will earn on assets.By purchasing a large number of different assets issued by a wide range of borrowers, financial intermediaries use diversification to help with risk sharing.

Example: by lending to a large number of different businesses, a bank might see a few of its loans go bad; but most of the loans will be repaid, making the overall return less risky.

Here, again, the bank is taking advantage of economies of scale, since it would be difficult for a smaller investor to make a large number of loans.

4- Asymmetric information: Adverse Selection and Moral Hazard. One party often does not know enough about the other party to make accurate decisions. This inequality is called asymmetric information. For example, a borrower who takes out a loan usually has better information about the potential returns and risk associated with the investment projects for which the funds are earmarked than the lender does. Lack of information creates problems in the financial system on two fronts: before the transaction is entered into and after.

Adverse selection is the problem created by asymmetric information before the transaction occurs. Adverse selection in financial markets occurs when the potential borrowers who are the most likely to produce an undesirable (adverse) outcome—the bad credit risks—are the ones who most actively seek out a loan and are thus most likely to be selected. Because adverse selection makes it more likely that loans might be made to bad credit risks, lenders may decide not to make any loans even though there are good credit risks in the marketplace. Moral hazard is the problem created by asymmetric information after the transaction occurs. Moral hazard in financial markets is the risk (hazard) that the borrower might engage in activities that are undesirable (immoral) from the lender's point of view, because they make it less likely that the loan will be paid back. Because moral hazard lowers the probability that the loan will be repaid, lenders may decide that they would rather not make a loan.

Financial intermediaries also use their expertise to screen out bad credit risks and monitor borrowers. They thereby help solve two problems related to imperfect information in financial markets.

Adverse Selection = refers to the problem that arises before a loan is made because borrowers who are bad credit risks tend to be those who most actively seek out loans.
Financial intermediaries can help solve this problem by gathering information about potential borrowers and screening out bad credit risks.
Moral Hazard = refers to the problem that arises after a loan is made because borrowers may use their funds irresponsibly. Financial intermediaries can help solve this problem by monitoring borrowers' activities

Generally because of the problems of: 1) monitoring costs, 2) liquidity and transaction costs, 3) risk, and 4) asymmetric information credit/capital markets would not be very developed using only direct finance. However, using indirect finance through FIs, credit and capital markets develop to a much more advanced level, significantly increasing the volume of credit in the economy. FIs can more effectively and efficiently deal with the potential problems than individuals.

Services (functions) performed by financial intermediaries in the financial market:

✓ **Monitoring costs**- FI can act on behalf of a large group of investors/savers, and can monitor users of funds on behalf of borrowers and stockholders efficiently, due to economies of scale. For example, a) banks hire credit analysts to assess creditworthiness and they monitor businesses who borrow money, b) mutual funds and institutional investors can hire financial analysts to do market research and c) investment banks conduct research on companies for clients/fund suppliers in the underwriting process,

✓ **Liquidity service and asset transformation** -FIs provide liquidity service to credit/capital markets, services that make it easier for customers to conduct transactions. For example, banks and mutual funds allow depositors/investors to make an unlimited number of small deposits and withdrawals to their accounts, increasing liquidity. In addition, depositors can earn interest on checking and savings accounts and yet still convert them into goods and services whenever necessary. Further, the FIs provide additional claims to fund suppliers, thus acting as Asset Transformers i.e they issue financial claims(in form of deposits, insurance policies or other secondary securities) that are more attractive to investors than are the claims directly issued by corporations.

✓ **FIs increase diversification for savers/investors**, e.g. putting money in a bank deposit is an "investment" in a diversified loan portfolio. Diversification through a mutual fund is much easier, more efficient, lower cost than trying to diversify using direct finance in stocks, especially for an average investor.

✓ **Reduced transaction cost** because of **economies of scale**, FIs can achieve efficiencies due to their large scale of operations and significantly lower overall transaction costs. For example, spending $100 to buy a private research report on a new company is affordable for a $10B mutual fund, compared to an individual with a $10,000 investment buying the report.

✓ FIs provide **maturity intermediation.** Most depositors want to make short term deposits, but most borrowers want long term loans, e.g. borrowers/homeowners want 30 year mortgages but don't necessarily want to make 30 year bank deposits. Without FIs bearing the risk of maturity mismatch, there might not even be a long term mortgage market.

✓ FIs provide **denomination intermediation**, since some securities are sold in amounts beyond the reach of an average investor, e.g. min. $100,000 negotiable CDs and min. $250,000 commercial paper packages. By investing in a money market mutual fund, these investments become accessible to the average investor.

Other Economic Functions FIs Provide to the Economy

Depository institutions assist in the transmission of monetary policy, since they are the primary channel and conduit for the implementation of monetary policy.

✓ **Special credit markets** in the economy can be effectively served by FIs, - FIs are often viewed as the major and sometimes the only sources of financing for a particular sector of the economy, such as farming and residential real estates. e.g. savings and loans associations and thrifts institutions.

✓ **Intergenerational wealth transfers-** FIs especially life insurance companies and pension funds provide savers with ability to transfer wealth from one generation to the next.

✓ FIs provide valuable **payment services** to the economy; - depository institutions are also special in that the efficiency with which they provide payment service directly benefits the economy. Two important payment services are check-clearing and wire transfer services.

2.3 Categories of financial intermediaries

Dear learner, can you list some of the basic types of financial intermediaries?

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_____

We have seen why financial intermediaries play such an important role in the financial market and the economy. Now we look at the principal financial intermediaries themselves and how they perform the intermediation function. They fall into three categories: depository institutions (banks), contractual savings institutions, and investment intermediaries.

A. Depository Institutions

Depository institutions are financial intermediaries that accept deposits from individuals and institutions and make loans. The study of money and banking focuses special attention on this group of financial institutions, because they are involved in the creation of deposits, an important component of the money supply. These institutions include commercial banks and the so-called thrift institutions (thrifts): savings and loan associations, mutual savings banks, and credit unions.

B. Contractual Saving Institutions

Contractual savings institutions (life insurance companies, fire and casualty insurance companies, pension funds and government retirement funds) are financial intermediaries that acquire funds at periodic intervals on a contractual basis. Because they can predict with reasonable accuracy how much they will have to pay out in benefits in the coming years, they do not have to worry as much as depository institutions about losing funds. As a result, the liquidity of assets is not as important a consideration for them as it is for depository institutions, and they tend to invest their funds primarily in long-term securities such as corporate bonds, stocks, and mortgages.

C. Investment Intermediaries

Investment Intermediaries include finance companies, mutual funds, and money market mutual funds.

Finance Companies. Finance companies raise funds by selling commercial paper (a short-term debt instrument) and by issuing stocks and bonds. They lend these funds to consumers, who make purchases of such items as furniture, automobiles, and home improvements, and to small businesses. Some finance companies are organized by a parent corporation to help sell its product.

For example, Ford Motor Credit Co. makes loans to consumers who purchase Ford automobiles.

Mutual Funds. These financial intermediaries acquire funds by selling shares to many individuals and use the proceeds to purchase diversified portfolios of stocks and bonds. Mutual funds allow shareholders to pool their resources so that they can take advantage of lower transaction costs when buying large blocks of stocks or bonds. In addition, mutual funds allow shareholders to hold more diversified portfolios than they otherwise would. Shareholders can sell (redeem) shares at any time, but the value of these shares will be determined by the value of the mutual fund's holdings of securities. Because these fluctuate greatly, the value of mutual fund shares will too; therefore, investments in mutual funds can be risky.

Money Market Mutual Funds. These relatively new financial institutions have the characteristics of a mutual fund but also function to some extent as a depository institution because they offer deposit-type accounts. Like most mutual funds, they sell shares to acquire funds that are then used to buy money market instruments that are both safe and very liquid. The interest on these assets is then paid out to the shareholders. A key feature of these funds is that shareholders can write checks against the value of their shareholdings. In effect, shares in a money market mutual fund function like checking account deposits that pay interest.

Primary Assets and Liabilities of Financial Intermediaries:

Type of Intermediary	**Primary Liabilities (Sources of Funds)**	**Primary Asset (Uses of Funds)**
A. Depository institutions		
- Commercial banks	Deposits	Business and consumer loans, mortgages, government securities and municipal bond
- Savings and loan associations	Deposits	Mortgages, consumer
- Credit unions	Deposits	Consumer loans
- Mutual savings banks	Deposits	Mortgages
B. Contractual savings institutions		
- Insurance companies	Premiums from policies	Bonds, shares , mortgage and government securities
- Pension funds, government retirement funds.	Employee and employer contribution	Corporate bonds and stock
C. Investment intermediaries		
- Finance companies	Commercial paper, stocks and bonds	Consumer and business loans
- Mutual funds	Shares	Stocks and bonds
-Money market mutual funds	Shares	Money market instruments

2.1 Check Your Progress

1-What is the difference between Adverse Selection and Moral Hazard?

2-List the major functions of financial intermediaries?

3- Who are the depository institutions?

2.4 Financial Market Instruments

Dear leaner, Do you know what we mean by financial market instrument, if so, would you please list some of the major types of financial market instrument?

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Here we examine the securities (instruments) traded in financial markets. We first focus on the instruments traded in the money market and then turn to those traded in the capital market.

Because of their short terms to maturity, the debt instruments traded in the money market undergo the least price fluctuations and so are the least risky investments. The money market has undergone great changes in the past three decades, with the amount of some financial instruments growing at a far more rapid rate than others.

A) Money Market Instruments include

The money market instruments are issued for short terms / period of time in the financial market.

-Government Treasury Bills. These short-term debt instruments of any government which are issued in 3, 6, and 12 month maturities to finance the federal government. They pay a set amount at maturity and have no interest payments, but they effectively pay interest by initially selling at a discount, that is, at a price lower than the set amount paid at maturity. For instance, you might pay $9,000 in May 2011 for a one year Treasury Bill that can be redeemed in May 2012 for $10,000.

If we take the experiences of other countries, U.S. Treasury bills are the most liquid of all the money market instruments, because they are the most actively traded. They are also the safest of all money market instruments, because there is almost no possibility of *default*, a situation in which the party issuing the debt instrument (the federal government, in this case) is unable to make interest payments or pay off the amount owed when the instrument matures. The federal government is always able to meet its debt obligations, because it can raise taxes or issue *currency* (paper money or coins) to pay off its debts. Treasury bills are held mainly by banks, although small amounts are held by households, corporations, and other financial intermediaries.

-Negotiable Bank Certificates of Deposit. A *certificate of deposit* (*CD*) is a debt instrument, sold by a bank to depositors, that pays annual interest of a given amount and at maturity, pays back the original purchase price. Before 1961, CDs were not negotiable; that is, they could not be sold to someone else and could not be redeemed from the bank before maturity without paying a substantial penalty. In 1961, to make CDs more liquid and more attractive to investors, Citibank introduced the first negotiable CD in large denominations (over $100,000) that could be resold in a secondary market.

This instrument is now issued by almost all the major commercial banks and has been extremely successful, with the amount outstanding currently around $1.2 trillion. CDs are an extremely important source of funds for commercial banks, from corporations, money market mutual funds, charitable institutions, and government agencies.

Commercial Paper. *Commercial paper* is a short-term debt instrument issued by large banks and well-known corporations, such as General Motors and AT&T. Before the 1960s, corporations usually borrowed their short-term funds from banks, but since then they have come to rely more heavily on selling commercial paper to other financial intermediaries and corporations for their immediate borrowing needs; in other words, they engage in direct finance. Growth of the commercial paper market has been substantial.

Banker's Acceptances. These money market instruments are created in the course of carrying out international trade and have been in use for hundreds of years. A *banker's acceptance* is a bank draft (a promise of payment similar to a check) issued by a firm, payable at some future date, and guaranteed for a fee by the bank that stamps it "accepted." The firm issuing the instrument is required to deposit the required funds into its account to cover the draft. If the firm fails to do so, the bank's guarantee means that it is obligated to make good on the draft. The advantage to the firm is that the draft is more likely to be accepted when purchasing goods abroad, because the foreign exporter knows that even if the company purchasing the goods goes bankrupt, the bank draft will still be paid off. These "accepted" drafts are often resold in a secondary market at a discount and are therefore similar in function to Treasury bills.

Typically, they are held by many of the same parties that hold Treasury bills, and the amount outstanding has experienced limited growth.

Repurchase Agreements. *Repurchase agreements*, or *repos*, are effectively short-term loans (usually with a maturity of less than two weeks) in which Treasury bills serve as *collateral*, an asset that the lender receives if the borrower does not pay back the loan.

Repos are made as follows: A large corporation, such as General Motors, may have some idle funds in its bank account, say $1 million, which it would like to lend for a week. GM uses this excess $1 million to buy Treasury bills from a bank, which agrees to repurchase them the next week at a price slightly above GM's purchase price. The effect of this agreement is that GM makes a loan of $1 million to the bank and holds $1 million of the bank's Treasury bills until the bank repurchases the bills to pay off the loan. Repurchase agreements are a fairly recent innovation in financial markets, having been introduced in 1969. They are now an important source of bank funds (over $400 billion). The most important lenders in this market are large corporations.

Repo is an agreement involving the sale of securities by one party to another with a promise to repurchase the securities at specified price and on a specified date in the future. Repo is essentially a collateralized loan.

Federal (Fed) Funds. These are typically overnight loans between banks of their deposits at the Federal Reserve. The *federal funds* designation is somewhat confusing, because these loans are not made by the federal government or by the Federal Reserve, but rather by banks to other banks. One reason why a bank might borrow in the federal funds market is that it might find it does not have enough deposits at the Fed to meet the amount required by regulators. It can then borrow these deposits from another bank, which transfers them to the borrowing bank using the Fed's wire transfer system. This market is very sensitive to the credit needs of the banks, so the interest rate on these loans, called the federal funds rate, is a closely watched barometer of the tightness of credit market conditions in the banking system and the stance of monetary policy; when it is high, it indicates that the banks are strapped for funds, whereas when it is low, banks' credit needs are low.

Money Market Rates

Wednesday, June 3, **2003**

Following the Financial News

The *Wall Street Journal* publishes daily a listing of interestrates on many different financial instruments in its "Money Rates" column. (See "Today's Contents" on page 1 of the *Journal* for the location.)

The four interest rates in the "Money Rates" column that are discussed most frequently in the media are these:

• *Prime rate:* The base interest rate on corporate bank loans, an indicator of the cost of business borrowing from banks

• *Federal funds rate:* The interest rate charged on overnight loans in the federal funds market, a sensitive indicator of the cost to banks of borrowing funds from other banks and the stance of monetary policy

• *Treasury bill rate:* The interest rate on U.S. Treasury bills, an indicator of general interest-rate movements.

• *Federal Home Loan Mortgage Corporation rates:* Interest rates on "Freddie Mac"–guaranteed mortgages, an indicator of the cost of financing residential housing purchases.

MONEY RATES

The key U.S., and foreign annual interest rates below are a guide to general

levels but don't always represent actual transactions.

PRIME RATE: 4.25% (effective 11/07/02).

DISCOUNT RATE: 2.25% (effective 01/09/03).

FEDERAL FUNDS: 1.250% high, 1.000% low, 1.125% near closing bid, 1.188% offered. Effective rate: 1.22%. Source: Prebon Yamane (USA) Inc. Federal-funds target rate: 1.250% (effective 11/06/02).

CALL MONEY: 3.00% (effective 11/07/02).

COMMERCIAL PAPER: Placed directly by General Electric Capital Corp.:

1.05% 30 to 35 days; 1.24% 36 to 43 days; 1.23% 44 to 70 days; 1.21% 71 to 99 days; 1.19% 100 to 113 days; 1.05% 114 to 122 days; 1.19% 123 to 143 days; 1.17% 144 to 270 days.

EURO COMMERCIAL PAPER: Placed directly by General Electric Capital Corp.: 2.25% 30 days; 2.20% two months; 2.19% three months; 2.15% four months; 2.14% five months; 2.13% six months.

DEALER COMMERCIAL PAPER: High-grade unsecured notes sold through dealers by major corporations: 1.21% 30 days; 1.20% 60 days; 1.19% 90 days.
CERTIFICATES OF DEPOSIT: 1.26% one month; 1.21% three months; 1.18% six months.
BANKERS ACCEPTANCE: 1.25% 30 days; 1.22% 60 days; 1.19% 90 days; 1.17% 120 days; 1.16% 150 days; 1.14% 180 days; Source: Prebon Yamane (USA) Inc.
LONDON INTERBANK OFFERED RATES (LIBOR): 1.31875% one month; 1.2800% three months; 1.2300% six months; 1.2300% one year. Effective rate for contracts entered into two days from date appearing at top of this column.
EURO INTERBANK OFFERED RATES (EURIBOR): 2.319% one month; 2.235% three months; 2.179% six months; 2.122% one year. Source: Reuters.
FOREIGN PRIME RATES: Canada 5.00%; European Central Bank 2.50%; Japan 1.375%; Switzerland 2.25%; Britain 3.75%
TREASURY BILLS: Results of the Monday, June 2, 2003, auction of short term U.S. government bills, sold at a discount from face value in units of $1,000 to $1 million: 1.110% 13 weeks; 1.095% 26 weeks. Tuesday, June
3, 2003 auction: 1.140% 4 weeks.
OVERNIGHT REPURCHASE RATE: 1.22%. Source: Garban Intercapital
FREDDIE MAC: Posted yields on 30-year mortgage commitments. Delivery within 30 days 4.68%, 60 days 4.80%, standard conventional fixed-rate mortgages: 2.875%, 2% rate capped one-year adjustable rate mortgages.
FANNIE MAE: Posted yields on 30 year mortgage commitments (priced at par) for delivery within 30 days 4.78%, 60 days 4.87% standard conventional fixed-rate mortgages; 3.00% 6/2 rate capped one-year adjustable rate mortgages. Constant Maturity Debt Index: 1.193% three months; 1.119% six months; 1.187% one year
MERRILL LYNCH READY ASSETS TRUST: 0.78%.
CONSUMER PRICE INDEX: April 183.8, up 2.2% from a year ago. Bureau of Labor Statistics.

Sources: Miskin, 2006

B) Capital market

Capital market instruments are debt and equity instruments with maturities of greater than one year. They have far wider price fluctuations than money market instruments and are considered to be fairly risky investments.

Stocks: Stocks are equity claims on the net income and assets of a corporation. For example if we take US stock market; their value of $11 trillion at the end of 2002 exceeds that of any other type of security in the capital market. The amount of new stock issues in any given year is typically quite small—less than 1% of the total value of shares outstanding. Individuals hold around half of the value of stocks; the rest are held by pension Marco funds, mutual funds, and insurance companies.

Mortgages: Mortgages are loans to households or firms to purchase housing, land, or other real structures, where the structure or land itself serves as collateral for the loans. The mortgage market is the largest debt market in the United States, with the amount of residential mortgages (used to purchase residential housing) outstanding more than quadruple the amount of commercial and farm mortgages. Savings and loan associations and mutual savings banks have been the primary lenders in the residential mortgage market, although commercial banks have started to enter this market more aggressively.

The majority of commercial and farm mortgages are made by commercial banks and life insurance companies. Since there is no well developed mortgage in our country, let we take the case of US as follows. The federal government plays an active role in the mortgage market via the three government agencies—the Federal National Mortgage Association (FNMA, "Fannie Mae"), the Government National Mortgage Association (GNMA, "Ginnie Mae"), and the Federal Home Loan Mortgage Corporation (FHLMC, "Freddie Mac")—that provide funds to the

mortgage market by selling bonds and using the proceeds to buy mortgages. An important development in the residential mortgage market in recent years is the mortgage-backed security

Corporate Bonds: These are long-term bonds issued by corporations with very strong credit ratings. The typical corporate bond sends the holder an interest payment twice a year and pays off the face value when the bond matures. Some corporate bonds, called convertible bonds, have the additional feature of allowing the holder to convert them into a specified number of shares of stock at any time up to the maturity date.

This feature makes these convertible bonds more desirable to prospective purchasers than bonds without it, and allows the corporation to reduce its interest payments, because these bonds can increase in value if the price of the stock appreciates sufficiently.

Because the outstanding amount of both convertible and nonconvertible bonds for any given corporation is small, they are not nearly as liquid as other securities such as U.S. government bonds.

Although the size of the corporate bond market is substantially smaller than that of the stock market, with the amount of corporate bonds outstanding less than one fourth that of stocks, the volume of new corporate bonds issued each year is substantially greater than the volume of new stock issues. Thus the behavior of the corporate bond market is probably far more important to a firm's financing decisions than the behavior of the stock market. The principal buyers of corporate bonds are life insurance companies; pension funds and households are other large holders.

Government Securities: These long-term debt instruments are issued by the National Bank of Ethiopia or central Bank of any country to finance the deficits of the federal government. Because they are the most widely traded bonds in the our country they are the most liquid security traded in the capital market. They are held by the Federal Reserve, banks, households, and foreigners.

Government Agency Securities: These are long-term bonds issued by various government agencies such as: Development Bank of Ethiopia, City Administration of Addis Ababa etc in our country and in U.S. Ginnie Mae, the Federal Farm Credit Bank, and the Tennessee Valley Authority to finance such items as mortgages, farm loans, or power generating equipment. Many of these securities are guaranteed by the federal government.

They function much like government bonds and are held by similar parties.

State and Local Government Bonds: State and local bonds, also called municipal bonds, are long-term debt instruments issued by state and local governments to finance expenditures on schools, roads, and other large programs. An important feature of these bonds is that their interest payments are exempt from federal income tax and generally from state taxes in the issuing state. Commercial banks, with their high income tax rate, are the biggest buyers of these securities, owning over half the total amount outstanding. The next biggest group of holders consists of wealthy individuals in high income brackets, followed by insurance companies.

Consumer and Bank Commercial Loans: These are loans to consumers and businesses made principally by banks, but—in the case of consumer loans—also by finance companies.

There are often no secondary markets in these loans, which makes them the least liquid of the capital market instruments. However, secondary markets have been rapidly developing.

Foreign bonds — sold in a foreign country and are denominated in that country's currency.

A Eurobond -is an international bond denominated in a currency other than that of the country in which it is sold. More precisely, it is issued by a borrower in one country, denominated in the borrower's currency, and sold outside the borrower's country.

Derivative products — financial instruments derived from financial products bought and sold in the spot market. They include options and futures. A future contract is a purchase contract stipulating that a particular asset to be delivered at a predetermined future date. An option is the

right, but not the obligation, to buy or sell an asset on or before a particular date.('Call' option — purchase; 'Put' option — sell.)

2.5. Summary

Financial intermediation consists of "channeling funds between surplus and deficit agents''. A financial intermediary is an entity that connects surplus and deficit agents. The classic example of a financial intermediary is a bank that transforms bank deposits into bank loans. As such, financial intermediaries channel funds from people who have extra money (savers) to those who do not have enough money to carry out a desired activity (borrowers).

To this effect this chapter addresses the basic function that a financial intermediary plays in the economy such as: Reducing Monitoring costs, Transaction cots, Risk sharing and reducing problem related to information Asymmetry. And, financial intermediaries fall into three categories: depository institutions (banks), contractual savings institutions, and investment intermediaries. Besides the above discussion, it is evident that Financial Market Instruments are classified in to money and capital market each of each are also further classified in to many.

Self Assessment questions 2

Part I-Multiple Question: Chose the best answer among the alternative given below each questions.

1. What do you understand by the term financial intermediaries?

A) Arbitrators who settle commercial disputes outside court.

B) Persons who take financial decisions for a firm using the power of attorney.

C) Software / accountings firm hired by a bank to do back office functions.

D) Institutions that act as middleman between those who want to lend and those who want to borrow.

E) B & C F) A & D G) A, B & D

2. Which of the following is an example of financial intermediary?

A) Competition Commission

B) CAG

C) Banking ombudsman

D) LIC E) A & C F) C & D

3. Financial intermediaries are

a. Non-essential for a country.

b. Essential for a country.

c. Essential for a communist country but non-essential for a capitalist country.

d. None of above.

4. A financial intermediary is in a stronger position than an individual investor due to

a. economies of scale

b. asymmetry of information

c. investments in diversified portfolios

d. All of above.

5. Which of the following do not belong to capital market?

A) Bond B) Mortgage C) Stock D) Treasury bill

Part II: True or False: write true if the statement is correct and false if it is not correct.

1) Capital market instruments are debt and equity instruments with maturities of greater than one year. They have far wider price fluctuations than money market instruments and are considered to be fairly risky investments.

2) Depository institutions (life insurance companies, fire and casualty insurance companies, pension funds and government retirement funds) are financial intermediaries that acquire funds at periodic intervals on a contractual basis.

3) Adverse selection is the problem created by asymmetric information before the transaction occurs.

4) Economic agents for whom receipts are higher than expenditures are called surplus units, savers, or ultimate lenders.

5) Transaction cost, the time and money spent in carrying out financial transactions, are a major problem for people who have excess funds to lend.

CHAPTER THREE: FINANCIAL MARKETS

3.0 Objectives:

After completing this chapter, you should be able to

- ✓ Understand the concept of financial market.
- ✓ Identify the types of financial market.
- ✓ Explain the basic functions of financial market.
- ✓ Understand the major players in the financial market.
- ✓ Examine how information is relevant in financial market.

3.1 Introduction to Financial Markets

Dear learner, Congratulations!!! You have successfully completed the first two chapters, now this is the third chapter, So, Can you say something about financial market?

Let we take the following simple example to have a clear understanding about financial market. Inez (name of a person) the Inventor has designed a low-cost robot that cleans house (even does windows), washes the car, and mows the lawn, but she has no funds to put her wonderful invention into production. Walter the Widower has plenty of savings, which he and his wife accumulated over the years. If we could get Inez and Walter together so that Walter could provide funds to Inez, Inez's robot would see the light of day, and the economy would be better off: We would have cleaner houses, shinier cars, and more beautiful lawns.

Financial markets (bond and stock markets) and financial intermediaries (banks, insurance companies, pension funds) have the basic function of getting people like Inez and Walter together by moving funds from those who have a surplus of funds (Walter) to those who have a shortage of funds (Inez). More realistically, when IBM invents a better computer, it may need funds to bring it to market. Similarly, when a local government needs to build a road or a school, it may need more funds than local property taxes provide. Well-functioning financial markets and financial intermediaries are crucial to economic health.

To study the effects of financial markets and financial intermediaries on the economy, we need to acquire an understanding of their general structure and operation. In this chapter, we learn about the major financial intermediaries and the instruments that are traded in financial markets as well as how these markets are regulated.

This chapter presents an overview of the fascinating study of financial markets.

3.2 Function of Financial Markets

Dear learner, what do you think is the important functions of financial markets?

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Financial markets perform the essential economic function of channeling funds from households, firms, and governments that have saved surplus funds by spending less than their income to those that have a shortage of funds because they wish to spend more than their income. Those who have saved and are lending funds, the lender-savers, and those who must borrow funds to finance their spending, the borrower-spenders.

The principal lender-savers are households, but business enterprises and the government (particularly state and local government), as well as foreigners and their governments, The most important borrower-spenders are businesses and the government (particularly the federal government), but households and foreigners also borrow to finance their purchases of cars, furniture, and houses.

A *financial market* is a market in which financial assets are traded. In addition to enabling exchange of previously issued financial assets, financial markets facilitate borrowing and lending by facilitating the sale by newly issued financial assets. Examples of financial markets include the New York Stock Exchange (resale of previously issued stock shares), the U.S. government bond market (resale of previously issued bonds), and the U.S. Treasury bills auction (sales of newly issued T-bills). A *financial institution* is an institution whose primary source of profits is through financial asset transactions. Examples of such financial institutions include discount

brokers (e.g., Charles Schwab and Associates), banks, insurance companies, and complex multi-function financial institutions such as Merrill Lynch.

In *direct finance* , borrowers borrow funds directly from lenders in financial markets by selling them *securities* (also called *financial instruments*), which are claims on the borrower's future income or assets. Securities are assets for the person who buys them but liabilities (IOUs 'I owe you' or debts) for the individual or firm that sells (issues) them. For example, if General Motors needs to borrow funds to pay for a new factory to manufacture electric cars, it might borrow the funds from savers by selling them *bonds*, debt securities that promise to make payments periodically for a specified period of time.

Why is this channeling of funds from savers to spenders so important to the economy?

The answer is that the people who save are frequently not the same people who have profitable investment opportunities available to them, the entrepreneurs. Let's first think about this on a personal level. Suppose that you have saved br1,000 this year, but no borrowing or lending is possible because there are no financial markets.

If you do not have an investment opportunity that will permit you to earn income with your savings, you will just hold on to the br1,000 and will earn no interest.

However, Mr Bekele the Carpenter has a productive use for your br1,000: He can use it to purchase a new tool that will shorten the time it takes him to build a house, thereby earning an extra br 200 per year. If you could get in touch with Mr Bekele, you could lend him the br1,000 at a rental fee (interest) of br100 per year, and both of you would be better off. You would earn br 100 per year on your br1,000, instead of the zero amount that you would earn otherwise, while Carl would earn br100 more income per year (the br200 extra earnings per year minus the br100 rental fee for the use of the funds).

In the absence of financial markets, you and Bekele the Carpenter might never get together. Without financial markets, it is hard to transfer funds from a person who has no investment

opportunities to one who has them; you would both be stuck with the status quo, and both of you would be worse off. Financial markets are thus essential to promoting economic efficiency.

The existence of financial markets is also beneficial even if someone borrows for a purpose other than increasing production in a business. Say that you are recently married, have a good job, and want to buy a house. You earn a good salary, but because you have just started to work, you have not yet saved much. Over time, you would have no problem saving enough to buy the house of your dreams, but by then you would be too old to get full enjoyment from it. Without financial markets, you are stuck; you cannot buy the house and must continue to live in your tiny apartment.

If a financial market were set up so that people who had built up savings could lend you the funds to buy the house, you would be more than happy to pay them some interest in order to own a home while you are still young enough to enjoy it. Then, over time, you would pay back your loan. The overall outcome would be such that you would be better off, as would the persons who made you the loan. They would now earn some interest, whereas they would not if the financial market did not exist.

Now we can see why financial markets have such an important function in the economy. They allow funds to move from people who lack productive investment opportunities to people who have such opportunities. Thus financial markets are critical for producing an efficient allocation of capital, which contributes to higher production and efficiency for the overall economy. Indeed, as we will explore in when financial markets break down during financial crises, as they have in Mexico, East Asia, and Argentina in recent years, severe economic hardship results, which can even lead to dangerous political instability.

Well-functioning financial markets also directly improve the well-being of consumers by allowing them to time their purchases better. They provide funds to young people to buy what they need and can eventually afford without forcing them to wait until they have saved up the entire purchase price. Financial markets that are operating efficiently improve the economic welfare of everyone in the society.

Thus, we can summarize the basic functions of Financial Markets as follows:

- **Borrowing and Lending:** Financial markets permit the transfer of funds (purchasing power) from savers who have spent less than their income to investors or consumers who have spending needs that exceed their income.
- **Price Determination:** Financial markets provide vehicles by which prices are set both for newly issued financial assets and for the existing stock of financial assets.
- **Information Aggregation and Coordination:** Financial markets act as collectors and aggregators of information about financial asset values and the flow of funds from lenders to borrowers.
- **Risk Sharing:** Financial markets allow a transfer of risk from those who undertake investments to those who provide funds for those investments.
- **Liquidity:** Financial markets provide the holders of financial assets with a chance to resell or liquidate these assets.
- **Efficiency:** Financial markets reduce transaction costs and information costs. In attempting to characterize the way financial markets operate, one must consider both the various types of financial institutions that participate in such markets and the various ways in which these markets are structured.

3.1 Check Your Progress

1-What is the difference between financial market and financial institutions?

2-List the basic functions of financial market?

3- Why is this channeling of funds from savers to spenders so important to the economy?

3.3 Structure of Financial Markets

Dear learner, what are the major categorizations of the financial markets?

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The main participants in financial market transactions are households, businesses (including financial institutions), and governments that purchase or sell financial assets. Those participate that provide funds are called surplus units; while participants markets to obtain funds are called deficits Units the Treasury finances the budget deficit by issuing Treasury securities. The main providers of funds are households. Foreign investors also commonly invest in US. Treasury securities, as does the Federal Reserve System (the Fed). The Fed plays a major role in the financial markets because it controls the US. Money supply and participates in the regulation of depository institutions. In our country it is the National Bank of Ethiopia, which regulates the supply of money as fed does for US.

Now that we understand the basic function of financial markets, let's look at their structure. The following descriptions of several categorizations of financial markets

a) Money versus Capital Markets

One way to distinguish between markets is on the basis of the maturity of the securities traded in each market. The **money market** is a financial market in which only short-term debt instruments (generally those with original maturity of less than one year) are traded; the **capital market** is the market in which longer-term debt (generally those with original maturity of one year or greater) and equity instruments are traded. Money market securities are usually more widely traded than longer-term securities and so tend to be more liquid.

Financial markets facilitate the flow of funds from surpluses units to defect unit Those financial markets that facilitate the flow of short-term funds (with maturities of less than one year) are known as money markets, while those that facilitate the flow of long-term funds are known as capital markets. Securities with maturity of one year or less are called money market securities, whereas securities with a maturity of more than one year are called capital market securities. Money market scurries generally have a higher degree of liquidity (can be liquidated easily

without a loss of value). However, capital market securities are typically expected to generate a higher annualized return to investors.

b) Primary versus Secondary Markets

Whether referring to transactions involving money market securities or capital market securities, it is necessary to distinguish between transactions in the primary market versus transactions in the secondary market. Primary markets facilitate the issuance of new securities, while secondary markets facilitate the trading of existing securities. Primary market transactions provide funds to the initial issuer of securities; secondary market transactions do not. Some securities have a more active secondary market and are therefore snore marketable than others. This is an important feature for financial market participants if they plan to sell security holdings prior to maturity The issuance of new corporate stock or new Treasury securities represents a primary market transaction, while the sale of existing corporate stock or Treasury security holdings by any businesses or individuals represents a secondary market transaction.

c) Organized Versus Over-the-Counter Markets

Secondary markets can be organized in two ways. One is to organize **exchanges**, where buyers and sellers of securities (or their agents or brokers) meet in one central location to conduct trades. The New York and American stock exchanges for stocks and the Chicago Board of Trade for commodities (wheat, corn, silver, and other raw materials) are examples of organized exchanges.

Organized Exchanges, such as the New York Stock Exchange, which combine auction and OTC market features. Specifically, organized exchanges permit buyers and sellers to trade with each other in a centralized location, like an auction. However, securities are traded on the floor of the exchange with the help of *specialist traders* who combine broker and dealer functions. The specialists broker trades but also stand ready to buy and sell stocks from personal inventories if buy and sell orders do not match up.

The other method of organizing a secondary market is to have an **over-the counter (OTC) market**, An *over-the-counter market* has no centralized mechanism or facility for trading. Instead, the market is a public market consisting of a number of dealers spread across a region, a country, or indeed the world, who *make the market* in some type of asset. That is, the dealers themselves post bid and asked prices for this asset and then stand ready to buy or sell units of

this asset with anyone who chooses to trade at these posted prices. The dealers provide customers more flexibility in trading than brokers, because dealers can offset imbalances in the demand and supply of assets by trading out of their own accounts. Many well-known common stocks are traded over-the-counter in the United States through NASDAQ (National Association of Securies Dealers' Automated Quotation System)

d) Debt versus Equity Markets:

Debt instruments are particular types of securities that require the issuer (the borrower) to pay the holder (the lender) certain fixed dollar amounts at regularly scheduled intervals until a specified time (the maturity date) is reached, regardless of the success or failure of any investment projects for which the borrowed funds are used. A debt instrument holder only participates in the management of the debt instrument issuer if the issuer goes bankrupt. An example of a debt instrument is a 30-year mortgage.

In contrast, an *equity* is a security that confers on the holder an ownership interest in the issuer. There are two general categories of equities: "preferred stock" and "common stock."
Common stock shares issued by a corporation are claims to a share of the assets of a corporation as well as to a share of the corporation's net income -- i.e., the corporation's income after subtraction of taxes and other expenses, including the payment of any debt obligations. This implies that the return that holders of common stock receive depends on the economic performance of the issuing corporation.

Holders of a corporation's common stock typically participate in any upside performance of the corporation in two ways: by receiving a share of net income in the form of dividends; and by enjoying an appreciation in the price of their stock shares. However, the payment of dividends is not a contractual or legal requirement. Even if net earnings are positive, a corporation is not obliged to distribute dividends to shareholders. For example, a corporation might instead choose to keep its profits as retained earnings to be used for new capital investment (self-financing of investment rather than debt or equity financing).

On the other hand, corporations cannot charge losses to their common stock shareholders. Consequently, these shareholders at most risk losing the purchase price of their shares, a situation which arises if the market price of their shares declines to zero for any reason. An example of a common stock share is a share of IBM.

In contrast, *preferred stock shares* are usually issued with a par value (e.g., $100) and pay a fixed dividend expressed as a percentage of par value. Preferred stock is a claim against a corporation's cash flow that is prior to the claims of its common stock holders but is generally subordinate to the claims of its debt holders. In addition, like debt holders but unlike common stock holders, preferred stock holders generally do not participate in the management of issuers through voting or other means unless the issuer is in extreme financial distress (e.g., insolvency). Consequently, preferred stock combines some of the basic attributes of both debt and common stock and is often referred to as a *hybrid security*.

e) International and Domestic Markets

Financial markets can be classified as either domestic or international markets. The most important international financial markets for U.S. firms are the short-term Eurodollar market and the long-term Eurobond market. In these markets, domestic or overseas firms can borrow or lend large amounts of U.S. dollars that have been deposited in overseas banks. These markets are closely linked to U.S. money and capital markets. Large financial institutions, business firms, and institutional investors, both in the United States and overseas, conduct daily transactions between the U.S. domestic markets and the international markets.

f) Spot Market and Futures Market

The spot market is the market in which securities are traded for immediate delivery and payment. The term “immediate” can mean the same day or a week later depending on the particular market. The spot market is also called the cash market.

The futures market is the market in which securities are traded for future delivery at a specified price. The instruments traded in this market are called futures contracts. Futures contracts trade on organized exchanges such as the Chicago board of Trade, and their contracts are standardized.

If the futures contract is negotiated and sold over the counter, it is referred to as a forward contract and the market is referred to as a forward market. For example, currencies such as the dollar or yen are sold as forward contracts negotiated between two parties. Currencies are also sold as futures contracts on futures exchanges. Futures contracts in foreign exchange markets are similar to forward contracts, except that they are standardized and sold on an organized exchange.

g) Option Market

The option market is the market in which securities are traded for conditional future delivery. The instruments traded are called option contracts. The option contract call for one party (the option writer) to perform a specific act if called jupon by the option holder. Typically, an option gives parties the right to buy or sell a security such as a particular stock or bond. The option contract stipulates the price at which the security is to be bought or sold and the date on which the ability to exercise the option expires. For example, a put option allows an investor to sell (put) a security back to the issuer at a predetermined price by a certain date. A call option allows the issuer of a security to purchase (call) a particular security for a predetermined price by a certain date. Option contracts on securities are traded on most major organized exchanges such as the American Stock Exchange (AMEX), and options on commodities are traded on commodity exchanges such as the Chicago Board of Trade.

h) Derivatives Markets

The derivative is named so for a reason: its value is derived from its underlying asset or assets. A derivative is a contract, but in this case the contract price is determined by the market price of the core asset. If that sounds complicated, it's because it is. The derivatives market adds yet another layer of complexity and is therefore not ideal for inexperienced traders looking to speculate. However, it can be used quite effectively as part of a risk management program. (To get to know derivatives, read *The Barnyard Basics Of Derivatives*.)

Examples of common derivatives are forwards, futures, options, swaps and contracts-for-difference (CFDs). Not only are these instruments complex but so too are the strategies deployed by this market's participants. There are also many derivatives, structured products and

collateralized obligations available, mainly in the over-the-counter (non-exchange) market, that professional investors, institutions and hedge fund managers use to varying degrees but that play an insignificant role in private investing.

i) Forex and the Interbank Market

The interbank market is the financial system and trading of currencies among banks and financial institutions, excluding retail investors and smaller trading parties. While some interbank trading is performed by banks on behalf of large customers, most interbank trading takes place from the banks' own accounts.

The forex market is where currencies are traded. The forex market is the largest, most liquid market in the world with an average traded value that exceeds $1.9 trillion per day and includes all of the currencies in the world. The forex is the largest market in the world in terms of the total cash value traded, and any person, firm or country may participate in this market.

There is no central marketplace for currency exchange; trade is conducted over the counter. The forex market is open 24 hours a day, five days a week and currencies are traded worldwide among the major financial centers of London, New York, Tokyo, Zürich, Frankfurt, Hong Kong, Singapore, Paris and Sydney.

Until recently, forex trading in the currency market had largely been the domain of large financial institutions, corporations, central banks, hedge funds and extremely wealthy individuals. The emergence of the internet has changed all of this, and now it is possible for average investors to buy and sell currencies easily with the click of a mouse through online brokerage accounts.

3.2 Check Your Progress

1-Distiniguish money and capital market?

2- Write the difference between organized and over counter trade?

3- Is there any difference between Spot Market and Futures Market ? If yes, please write their differences ?

3.4 Who are the Major Players in Financial Markets?

Dear learner, whom do you think are the major players in the financial markets?

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By definition, financial institutions are institutions that participate in financial markets, i.e., in the creation and/or exchange of financial assets. At present in the United States, financial institutions can be roughly classified into the following four categories: "brokers;" "dealers;" "investment bankers;" and "financial intermediaries."

a) BROKERS: A broker is a commissioned agent of a buyer (or seller) who facilitates trade by locating a seller (or buyer) to complete the desired transaction. A broker does not take a position in the assets he or she trades -- that is, the broker does not maintain inventories in these assets. The profits of brokers are determined by the commissions they charge to the users of their services (the buyers, the sellers, or both).

Examples of Brokers: Real estate brokers, stock brokers.

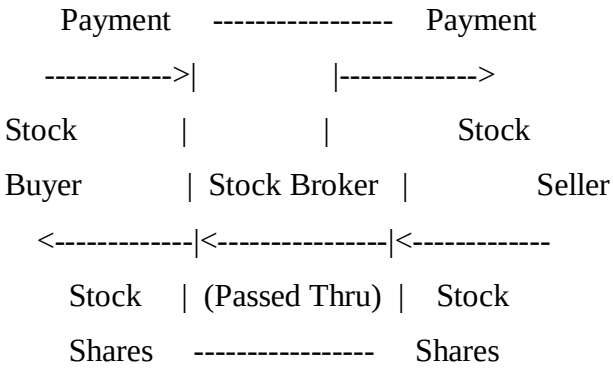


Figure 6: *Diagrammatic Illustration of a Stock Broker:*

b) DEALERS: Like brokers, dealers facilitate trade by matching buyers with sellers of assets; they do not engage in asset transformation. Unlike brokers, however, a dealer can and does "take positions" (i.e., maintain inventories) in the assets he or she trades that permit the dealer to sell out of inventory rather than always having to locate sellers to match every offer to buy.

Also, unlike brokers, dealers do not receive sales commissions. Rather, dealers make profits by buying assets at relatively low prices and reselling them at relatively high prices (buy low - sell high). The price at which a dealer offers to sell an asset (the asked price) minus the price at which a dealer offers to buy an asset (the bid price) is called the bid-ask spread and represents the dealer's gross profit margin on the asset exchange.

Examples of Dealers: Used-car dealers, dealers in U.S. government bonds, and Nasdaq stock dealers.

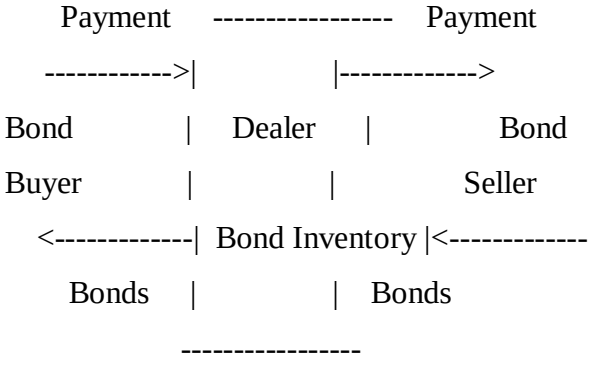


Figure7: *Diagrammatic Illustration of a Bond Dealer:*

c) INVESTMENT BANKS: Traditionally, *investment banks* have engaged in three basic types of activities:

✓ ***Advice***: Advising services, e.g., advice to corporations regarding possible mergers and acquisitions (M&A), or the timing and form of possible *IPOs = Initial Public Offerings* (i.e., sales of newly issued securities);

✓ ***Underwriting***: Guaranteeing corporations a price on the securities they offer through IPOs, either individually or by having several different investment banks form a syndicate to underwrite the issue jointly;

✓ ***Sales Assistance***: Assisting in the sale of IPO securites to the public.

Examples of Investment Banks: Some of the best-known U.S. investments banking firms are Morgan Stanley, Merrill Lynch, Salomon Brothers, First Boston Corporation, and Goldman Sachs. The financial crisis 2007-2009 led in 2008 to the collapse of Bear Stearns and Lehman Brothers, the acquisition of Merrill Lynch by Bank of America, and major changes in the organization of Goldman Sachs and Morgan Stanley.

d) Financial intermediaries: Unlike brokers, dealers, and investment banks, ***financial intermediaries*** are financial institutions that engage in financial asset transformation. That is, financial intermediaries purchase one kind of financial asset from borrowers -- generally some kind of long-term loan contract whose terms are adapted to the specific circumstances of the borrower (e.g., a mortgage) -- and sell a different kind of financial asset to savers, generally some kind of relatively liquid claim against the financial intermediary (e.g., a deposit account).

In addition, unlike brokers and dealers, financial intermediaries typically hold financial assets as part of an investment portfolio rather than as an inventory for resale. In addition to making profits on their investment portfolios, financial intermediaries make profits by charging relatively high interest rates to borrowers and paying relatively low interest rates to savers.

Types of financial intermediaries include: **Depository Institutions** (commercial banks, savings and loan associations, mutual savings banks, credit unions);**Contractual Savings Institutions** (life insurance companies, fire and casualty insurance companies, pension funds, government retirement funds); and **Investment Intermediaries** (finance companies, stock and bond mutual funds, money market mutual funds).

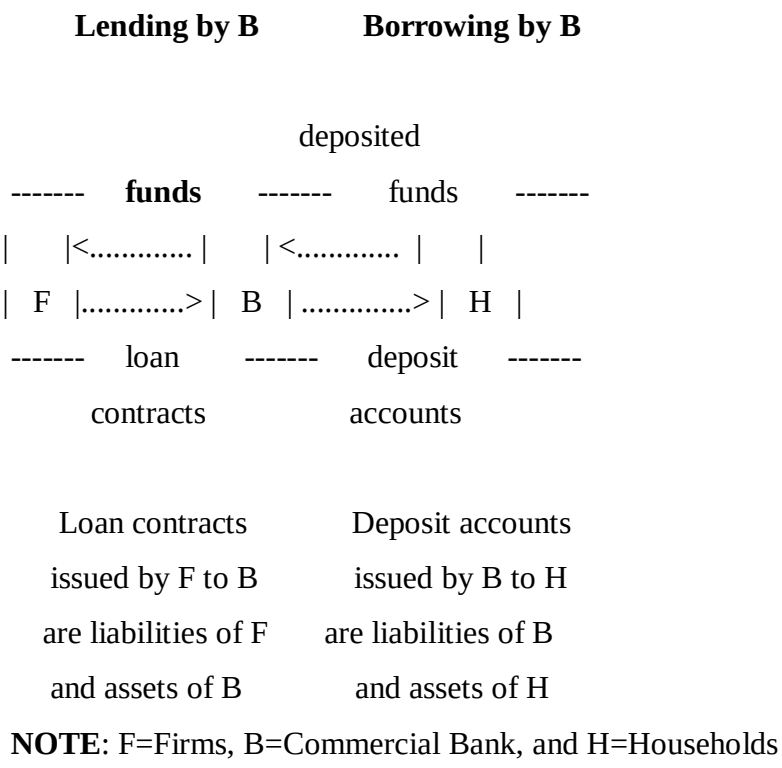


Figure 8: *Diagrammatic Example of a Financial Intermediary: A Commercial Bank*

Important Caution: These four types of financial institutions are simplified idealized classifications, and many actual financial institutions in the fast-changing financial landscape today engage in activities that overlap two or more of these classifications or even to some extent fall outside these classifications.

For example, as noted above, Merrill Lynch is an investment banker in the sense it is one of the key financial institutions that provides investment banking services both here in the United States and abroad. On the other hand, Merrill Lynch also engages heavily in brokering and dealership activities as well as providing money market accounts on which checks can be drawn. Thus, Merrill Lynch actually operates to some extent in all four of the above categories. The bottom line is that the ability to use the above four categories to distinguish among *separate institutions* (as opposed to the activities undertaken within institutions) is rapidly diminishing.

3.3. Check Your Progress

1) Identify the major players in the financial markets?

2-What is the difference between broker and dealers?

3-Who are financial intermediaries and how do you classify it?

3.5 Spot versus Futures, Forward, and Option Markets

Dear learner, what do you think of spot, future, forward and option market?

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We may also distinguish between spot markets, futures or forward markets, and option markets. ***A spot market*** is one in which assets or financial services are traded for immediate delivery (usually within one or two business days). If you pick up the telephone and instruct your broker to purchase X-Corporation shares at today's price, this is a spot market transaction. You expect to acquire ownership of X-Corporation shares within a matter of minutes.

A ***future or forward market***, on the other hand, is designed to trade contracts calling for the future delivery of financial instruments. For example, you may call your broker and ask to purchase a contract from another investor calling for delivery to you of Birr 1 million in Government bonds six months from today. The purpose of such a contract would be to reduce risk by agreeing on a price today rather than waiting six months, when government bond prices might have risen.

Finally, ***options markets*** also offer investors in the money and capital markets an opportunity to reduce risk. These markets make possible the trading of options on selected stocks and bonds, which are agreements (contracts) that given an investor the right to either buy from or sell designated securities to the writer of the option at a guaranteed price at any time during the life of the contract.

The Relationship between Forward and Spot Exchange Rates

To this point we have analyzed the reasons why spot and forward foreign exchange markets exist and explored some details of how those markets function. The question now is: What is the

relationship between the forward and spot exchange rates? In general, of course, the forward exchange rates on contracts of different lengths to maturity will differ from each other and from the spot rate at the time those forward contracts are entered into.

The forward discount on domestic currency is defined as the excess of the forward price of the foreign currency in terms of the domestic currency over its spot price, taken as a fraction or percentage of the spot price. That is,

$$\Psi = (\Pi' - \Pi)/\Pi$$

Where Ψ is the forward discount, Π' is the forward price of foreign currency in terms of domestic currency (for contracts of a particular length to maturity) and Π is the spot price of foreign currency in terms of domestic currency. A positive forward discount means that the purchaser of the foreign currency forward has to pay more domestic currency than he would have to pay to buy a unit of that foreign currency spot.

Let's take an example. Suppose that the forward rate is 360 yen per dollar and the spot rate is 350 yen per dollar. The forward discount on the yen will then be (360 - 350)/350 = .028, or 2.8 percent. Treating the dollar as the domestic currency, Π' is .0027777 and Π is .0028571. The forward discount on the dollar is thus

$$\Psi = (.0027777 - .0028571)/.0028571 = -.028.$$

The dollar is thus at a negative forward discount, or forward premium, in terms of the yen. A forward premium on the foreign currency (or forward discount on the domestic currency) signifies that the foreign currency can be purchased forward with domestic currency for less than it can be purchased spot or, alternatively, the domestic currency is worth less forward in foreign currency than it is worth spot.

Let us suppose now that the 3 month forward exchange rate of the yen in terms of the dollar is 355 yen per dollar while the current spot rate is 360 yen per dollar. Suppose further that you think that the spot exchange rate will not change over the next three months. If you are correct, you can make a profit by selling yen forward in return for dollars. A forward sale of 355 yen will net you one dollar. In 90 days when you have to fulfill the forward contract, you can use that dollar to purchase 360 yen for a net profit of 5 yen which, converted into dollars, amounts to 1.4

cents or 1.4 percent. Note that today's spot rate is really irrelevant---all that matters is the forward rate and the future spot rate.

This profit is, of course, a speculative one in that it depends on your being right about what the price of the yen in terms of the dollar is going to be in 3 months. If it turns out that a dollar was worth only 355 yen in three months when the forward contract matures, you will make nothing. If the dollar happens to be worth only 350 yen at that time you will lose---you will have to pay more than one dollar to obtain the 355 yen you have agreed to sell for one dollar under the forward contract.

You expected to gain by selling yen forward in the above situation because you believed that the yen would depreciate in relation to its current 90-day forward value during the next 90 days. If you think that the yen is going to appreciate in relation to its forward value, you would expect to gain by buying yen forward. In general, letting the expected future spot price of foreign currency be Πe, if $\Pi e > \Pi'$ there is an expected gain from selling the domestic currency forward and if $\Pi e < \Pi'$ there is an expected gain to purchasing the domestic currency forward.

It is thus clear that when foreign exchange traders and dealers expect that the future spot price of a currency in terms of another currency will be above the price at which that currency can be purchased forward they will all try to buy it forward. The current forward price of the currency will be bid up until such an expected gain is no longer possible. And when the market expects that the future spot price of a currency in terms of another currency is going to be below the current forward price, everyone will sell that currency forward in the expectation that they will be able to purchase it when the contract matures at a spot price below the agreed-upon forward sale-price. The current forward price of the currency will be bid down until an expected profit from doing this is no longer possible.

Any dealer or trader who is willing to ignore the risk can gain from foreign exchange market speculation whenever the expected future spot rate differs from the current forward rate. Given enough of such risk-neutral traders in the market, the forward exchange rate will be bid into equality with the expected future spot rate. The forward rate would then equal the market's estimate of where the spot rate will be when the contract matures.

Unfortunately, we cannot assume that foreign exchange speculators are indifferent to risk. In the Lesson entitled Asset Markets we concluded that the risk from holding an asset depends on the extent to which its return is positively correlated with the return on the entire bundle of assets held in people's portfolios and on how widely the its return fluctuates when the return on the entire portfolio fluctuates. Otherwise, the risk can be diversified away by holding the asset in a portfolio with many other assets whose returns are not correlated with its return. If holding three month forward yen is more risky than holding the average asset, a person with a contract to receive yen in, say, 30 days will require the forward price to be below the price she can expect to sell those yen for in 30 days when they are delivered under the contract. Similarly, a person holding a short position in yen will insist that the forward price of those yen be above the price at which she can expect to buy the yen 30 days hence for delivery under the contract. The forward discount can thus be expressed as

$$\Psi = (\Pi' - \Pi)/\Pi$$
$$= (\Pi' - \Pi e + \Pi e - \Pi)/\Pi$$
$$= (\Pi' - \Pi e)/\Pi + (\Pi e - \Pi)/\Pi$$

or

$$\Psi = \rho x + E\pi$$

Where $\rho x = (\Pi' - \Pi e)/\Pi$ is the risk premium on the domestic currency and $E\pi = (\Pi e - \Pi)/\Pi$ is the expected rate of change of the spot price of foreign currency in terms of domestic currency---that is the expected rate of depreciation of the domestic currency---over the contract period. This is known as the efficient markets condition.

The forward discount on domestic currency in terms of a foreign currency is equal to the expected rate of depreciation of the domestic currency in terms of foreign currency over the life of the forward contract plus a risk premium for holding it forward. New information that leads market participants to believe that the domestic currency will depreciate in terms of the foreign currency in the future will cause a forward discount to emerge as the forward rate gets bid into line with the expected future spot rate, assuming that risk factors do not change. This is another way of saying that expectations are rational---that all information about the future course of the

exchange rate is used by market participants in the market behavior that establishes the forward exchange rate. This will imply that the foreign exchange market is efficient.

3.4 Check Your Progress

It's time for a test! To get the best from the learning experience, construct your own answers before looking at the ones provided.

1-Suppose that the German mark is selling for 2.3 French francs and a German investor thinks that in 180 days this exchange rate will be FF (Franc) French 2.5 = DM 1. If there is no risk to the investor from a short-position in either marks or francs, he should sell francs short.

True or False?

2-Suppose that the spot price of the pound in terms of the dollar is $2.11 and the 1 month forward price is $2.00. A British currency trader who is willing to ignore risk considerations and thinks the pound will be worth $1.90 in one month's time should.

1. Sell pounds forward in return for dollars.
2. Sell dollars forward in return for pounds.
3. Buy pounds forward in return for dollars.
4. Do either 2. or 3.

3-You look in the Wall Street Journal and notice that the one-year forward price of the German mark in terms of the U.S. dollar is $0.48 and the current spot price of the mark in terms of the dollar is $0.46. This means that the market expects that during the next year the dollar will depreciate in terms of the mark by 4.35 percent.

True or False?

4-Suppose that the spot price of the Swiss franc in terms of the Australian dollar is 0.72 dollars. The 90-day forward price is A$ 0.81. A currency trader who is willing to ignore risk considerations and thinks the Swiss franc will be worth 0.90 Australian dollars in 90 days should

1. sell francs forward in return for Australian dollars.
2. sell Australian dollars forward in return for francs.
3. buy Swiss francs forward in return for the Australian dollars.
4. do either 2 or 3.

Choose the correct option.

3.6: Money Market

Dear learner, from the previous discussion made on chapter 3, what do you think is money market?

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3.6.1 Introduction

Investors realize that the stock market is a risky place for their savings. But they tend to forget fact while enjoying the returns of a stock market! Unfortunately, this is part of the risk-return tradeoff. To get higher returns, you have to take on a higher level of risk. For many investors, a volatile market is too much to stomach - the money market offers an alternative to these higher-risk investments.

The money market is better known as a place for large institutions and government to manage their short-term cash needs. However, individual investors have access to the market through a variety of different securities. In this material, we'll cover various types of money market securities and how they can work in investment portfolio.

3.6.2. Money market, what is it?

Money markets exist to transfer funds from individuals, corporations and government units with short-term excess funds (suppliers of funds) to economic agents who have short-term needs for funds (users of funds). The need for money market arises because the immediate needs of cash of individuals, corporations and governments do not necessarily coincide with their receipts of cash.

The money market is a subsection of the fixed income market. We generally think of the term fixed income as being synonymous to bonds. In reality, a bond is just one type of fixed income security. The difference between the money market and the bond market is that the money market specializes in very short-term debt securities (debt with original maturity of less than one year). Money market investments are also called cash investments because of their short term maturities.

Money market securities are essentially IOUs issued by governments, financial institutions and large corporations. These instruments are very liquid and considered extraordinarily safe. Because they are extremely conservative, money market securities offer significantly lower returns than most other securities.

One of the main differences between the money market and the stock market is that most money market securities trade in very high denominations. This limits access for the individual investor. Furthermore, the money market is a dealer market, which means that firms buy and sell securities in their own accounts, at their own risk. Compare this to the stock market where a broker receives commission to acts as an agent, while the investor takes the risk of holding the stock. Another characteristic of a dealer market is the lack of a central trading floor or exchange. Deals are transacted over the phone or through electronic systems.

The easiest way for us to gain access to the money market is with money market mutual funds, or sometimes through a money market bank account. These accounts and funds pool together the assets of thousands of investors in order to buy the money market securities on their behalf. However, some money market instruments, like Treasury bills, may be purchased directly.

The major participants of the money market are the government, commercial banks and other financial institutions, money market brokers and dealers and corporations. Individual investors are participated through money market mutual funds in most cases.

There are several different instruments in the money market, offering different returns and different risks. In the following sections, we'll take a look at the major money market instruments.

3.6.2.1 Money market Instruments

Dear learner, from the previous discussion made on chapter 2, what do you think are the major instruments in money market?

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1. Money Market: Treasury Bills (T-Bills)

Treasury Bills (T-bills) short term obligations of the government issued to cover government budget shortfalls (deficits) and to refinance maturity government debt. They are the most marketable money market security. Their popularity is mainly due to their simplicity. Essentially, T-bills are a way for the government to raise money from the public.

T-bills are short-term securities that mature in one year or less from their issue date. T-bills are purchased for a price that is less than their par (face) value; when they mature, the government pays the holder the full par value. Effectively, the interest is the difference between the purchase price of the security and what you get at maturity. For example, if you bought a 90-day T-bill at Br.9,800 and held it until maturity, you would earn Br.200 on your investment. This differs from coupon bonds, which pay interest semi-annually.

Issuing process- Treasury bills (as well as notes and bonds) are issued through a competitive bidding process at auctions. Submitted bids can be either competitive bids or non competitive bids. Competitive bids specify the desired quantity of T-bills and the bid price. The highest bidder receives the first allocation of T-bills and subsequent bids are filled in decreasing order of the bid until all T-bills auctioned are distributed. With non-competitive bids, the bidder indicates the quantity of T-bills he or she wants to buy and agrees to pay the weighted average price of the winning competitive bids. Non- competitive bidders get preferential allocation that is all these bids are met before the remaining T-bills are allocated to the competitive bidders.

The biggest reasons that T-Bills are so popular are that they are one of the few money market instruments that are affordable to the individual investors. T-bills are usually issued in denominations of Br1,000, Br5,000, Br10,000, Br25,000, Br50,000, Br100,000 and Br1 million. Other positives are that T-bills (and all Treasuries) are considered to be the safest investments in

the world because the government backs them. In fact, they are considered risk-free. Furthermore, they are exempt from state and local taxes.

The only downside to T-bills is that you won't get a great return because they are exceptionally safe. Other money market securities will often give higher rates of interest. What's more, you might not get back all of your investment if you cash out before the maturity date.

Dear learner, Have you known that the National Bank of Ethiopia (NBE) has issued treasure bills of various maturity date? Please, watch TV, or read Newspaper (Addis Zemen) to see how the NBE issue TB and write what you have observed?

Treasury bills Yields- as mentioned above the T- bills are sold at a discount thus the yield (return) comes from the difference between the purchase price paid for T-bills and the face value received at maturity.

The yield on T-bill is calculated as follows:

$$i_{T\text{-}bill} = \frac{FV - P_0}{FV} \times \frac{360}{D}$$

Where: $i_{T\text{-}bill}$ = Annualized yield on the T-bills

FV = Price (face value) paid to the T-bills holders

Po = Purchase price of the T-bill

D = Number of days until the T-bill matures

Example: Suppose you purchased a 91 day T-bill for $ 9,780. The T- bill has a face value of $10,000. The T-bill's discount yield is calculated as:

$$i_{T\text{-}bill} = \frac{\$10000 - \$9780}{\$10000} \times \frac{360}{91} = \mathbf{8.70\%}$$

2. Money Market: Certificate Of Deposit (CD)

Dear leaner, what do you think of CD?

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A certificate of deposit (CD) is a time deposit with a bank. CDs are generally issued by commercial banks but they can be bought through brokerages. They bear a specific maturity date (from three months to five years) and a specified interest rate. Like all time deposits, the funds may not be withdrawn on demand like those in a checking account. A CD is **bearer instrument** whoever holds the CD when it matures receives the principal and interest. It is actively traded in the secondary market.

Issuing process: banks issuing CDs post a daily set of rates for the most popular maturities of their CDs. Then subject to its funding requirement the bank tries to sell as many CDs to investors who are likely to hold them as investments. In some cases the bank and CD investor directly negotiate a rate, the maturity and the size of the CD. Once this is done the issuing bank delivers the CD to a custodian bank specified by the investor. The custodian bank verifies the CD, debits the amount to the investor's account and credits the amount to the issuing bank and the funds will be transferred to issuing bank. The CDs are usually issued in large denominations.

CDs offer a slightly higher yield than T-Bills because of the slightly higher default risk for a bank but, overall, the likelihood that a large bank will go broke is pretty slim. Of course, the amount of interest you earn depends on a number of other factors such as the current interest rate environment, how much money you invest, the length of time and the particular bank you choose. While nearly every bank offers CDs, the rates are rarely competitive, so it's important to shop around.

A fundamental concept to understand when buying a CD is the difference between annual percentage yield (APY) and annual percentage rate (APR). APY is the total amount of interest you earn in one year, taking compound interest into account. APR is simply the stated interest you earn in one year, without taking compounding into account.

The difference results from when interest is paid. The more frequently interest is calculated, the greater the yield will be. When an investment pays interest annually, its rate and yield are the same. But when interest is paid more frequently, the yield gets higher. For example, say you purchase a one-year, $1,000 CD that pays 5% semi-annually. After six months, you'll receive an interest payment of $25 ($1,000 x 5 % x .5 years). Here's where the magic of compounding starts. The $25 payment starts earning interest of its own, which over the next six months amounts to $ 0.625 ($25 x 5% x .5 years). As a result, the rate on the CD is 5%, but its yield is 5.06. It may not sound like a lot, but compounding adds up over time.

The main advantage of CDs is their relative safety and the ability to know your return ahead of time. You'll generally earn more than in a savings account, and you won't be at the mercy of the stock market.

Despite the benefits, there are two main disadvantages to CDs. First of all, the returns are paltry compared to many other investments. Furthermore, your money is tied up for the length of the CD and you won't be able to get it out without paying a harsh penalty.

CD Yields:

Example: a bank has issued a 6-month $1 million CD with a 7 % annual interest rate. Thus, the CD holder will receive**:**

FV= $1,000,000 (1 + 0.07/2) = $ 1,035,000

in six months in exchange for $1 million deposited in the bank today.

3. Money Market: Commercial Paper

Dear leaner, what do you think of commercial paper? Say something about it?

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For many corporations, borrowing short-term money from banks is often a laborious and annoying task. The desire to avoid banks as much as possible has led to the widespread popularity of commercial paper.

Commercial paper is an unsecured, short-term loan issued by a corporation, typically for financing working capital requirements such as accounts receivable and inventories. It is usually issued at a discount, reflecting current market interest rates. Maturities on commercial paper are usually no longer than nine months, with maturities of between one and two months being the average.

For the most part, commercial paper is a very safe investment because the financial situation of a company can easily be predicted over a few months. Furthermore, typically only companies with high credit ratings and credit worthiness issue commercial paper. Cases where corporations have defaulted on their commercial paper repayment are rare. However there is no active secondary market for commercial paper since commercial paper are unsecured debt. Thus, commercial paper is generally held from time of issue until maturity by investors.

Commercial paper is usually issued in denominations of 100,000 or more. Therefore, smaller investors can only invest in commercial paper indirectly through money market funds.

Commercial paper Yields: Like treasury bills, yields on commercial paper are quoted on discount basis.

$$i_{CP} = \frac{FV - P_0}{FV} \times \frac{360}{D}$$

Example: suppose an investor purchases 95-day commercial paper with a par value of $ 1000000 for a price of $985,000. The discount yield on the commercial paper is calculated as:

$$i_{CP} = \frac{\$\ 1000000 - 985000}{1000000} \times \frac{360}{95} = \mathbf{5.68}\ \%$$

3.5 Check Your Progress

1- Mr. Y has purchased a 30 day T-bill for $ 990,000. The T- bill has a face value of $1,000,000. The T-bill's discount yield is calculated as:

2- The bank of X has issued a 3-month $1 00,000 CD with a 5 % annual interest rate. Thus, the CD holder who is Mr. X will receive**:**

4. Money market: Banker's Acceptance

Dear leaner, what is banker's acceptance?

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A bankers' acceptance (BA) is a short-term credit investment created by a non-financial firm and guaranteed by a bank to make payment. It is a time draft payable to a seller of goods, with payment guaranteed by a bank. Money bankers acceptance arise from international trade transactions and the underlying letters of credit(or time drafts) that are used to finance trade in goods that have yet to be shipped from foreign exporter(seller) to domestic importer (buyer). This is especially useful when the creditworthiness of a foreign trade partner (the importer) is unknown.

The creation of a BA generally begins when a domestic importer after placing a purchase order from foreign exporter (1) arranges a letter of credit through its bank (2). The bank subsequently notifies the foreign exporter that upon meeting the delivery requirements the exporter is entitled to draw a time draft against the letter of credit at importer's bank(i.e withdraw money) for the amount of the transaction(3). After the export order is shipped(4) the foreign exporter presents the time draft and the shipping papers to its own (foreign) bank(5), who forwards these to the domestic importer's bank. The bank stamps the time draft as accepted and the draft becomes a banker's acceptance (6).

Then the bank returns the stamped time drafts(now a banker's acceptance) to the foreign exporter's bank and payment is made on the maturity date or the bank immediately pays the

foreign bank(implicitly the foreign exporter) the discounted value of the banker's acceptance(7). When the banker's acceptance matures, the domestic importer must pay its bank for the purchases (8) and the bank sends the domestic importer the shipping papers (9). Bankers' acceptances are traded at discounts from face value in the secondary market.

Acceptances sell at a discount from the face value:

Face Value of Banker's Acceptance	**$1,000,000**
Minus 2% Per Annum Commission for One Year	**-$20,000**
Amount Received by Exporter in One Year	**$980,000**

One advantage of a banker's acceptance is that it does not need to be held until maturity, and can be sold off in the secondary markets where investors and institutions constantly trade BAs.

5. Repurchase Agreements (Repo)

Dear leaner, what is Repo?

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Repo is short for repurchase agreement. Repo is an agreement involving the sale of securities by one party to another with a promise to repurchase the securities at specified price and on a specified date in the future. Repo is essentially a collateralized loan. Those who deal in government securities use repos as a form of overnight borrowing. A dealer or other holder of government securities (usually T-bills) sells the securities to a lender and agrees to repurchase them at an agreed future date at an agreed price. They are usually very short-term, from overnight to 30 days or more. This short-term maturity and government backing means repos provide lenders with extremely low risk.

Repos are popular because they can virtually eliminate credit problems. Unfortunately, a number of significant losses over the years from fraudulent dealers suggest that lenders in this market have not always checked their collateralization closely enough.

There are also variations on standard repos:

- **Reverse Repo** - The reverse repo is the complete opposite of a repo. In this case, a dealer buys government securities from an investor and then sells them back at a later date for a higher price.
- **Term Repo** - exactly the same as a repo except the term of the loan is greater than 30 days.

Repo yields: is calculated as the annualized percentage difference between the initial selling price of the securities and contracted purchase price (equals the selling price plus interest paid on the repurchase agreement),

$$i_{RA} = \frac{P_F - P_0}{Po} \times \frac{360}{D}$$

Where P_F = Repurchase price of the securities

Po = selling price of the securities

D = Number of days until the repo matures

Example: suppose a bank enters a reverse repurchase agreement in which it agrees to buy treasury securities from one of its correspondent banks at a price of $10,000,000, with the promise to sell these securities back at a price of $10,008,548 after five days. The yield on this repo to the bank is calculated as follows:

$$i_{RA} = \frac{\$10,008,548 - \$\ 10,000,000}{\$10,000,000} \times \frac{360}{5} = \mathbf{6.15}\%$$

6. Money market: Federal funds (overnight funds)

Federal funds are short term funds transferred between financial institutions, usually for a period of one day. The institution that borrows incurs a liability on its balance sheet while the institution that lends the funds records an asset. Overnight funds are single payment, unsecured loans that pay interest only once at maturity.

Federal funds Yield: interest rate divided by 360 or 365 days.

Example: if the 10000000 is lend at 6% rate of interest. The yield will be

10,000,000 X 0.06/360 = 1666.67.

7. Comparison of money market Securities

Money market securities have the following common characteristics**:**

– Large denomination with few exception

– Low default risk and lower returns

– Short maturities

– Tradable in the secondary market except commercial papers and federal funds though there is difference in terms of degree of activity. For instance T- bills are actively traded in secondary market where as the CDs secondary market is less active.

Check your Progress

Let we assume, a bank enters a reverse repurchase agreement in which it agrees to buy treasury securities from the famous correspondent banks at a price of $100,000,000, with the promise to sell these securities back at a price of $100,090,000 after 10 days. The yield on this repo will be?

3.8: Capital Market

Capital market: what is it?

Dear learner, from the previous discussion made on chapter 2 and 3, what is capital market?

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A capital market is a financial relationships created by a number of institutions and arrangements that allows suppliers and demanders of long-term funds (i.e funds with maturities exceeding one year) to make transactions. It is a market for securities (both debt and equity), where business enterprises (companies) and governments can raise long-term funds. It is defined as a market in which money is lent for periods longer than a year, as the raising of short-term funds takes place on other markets (i.e the money market). In capital market investors' handover money today in exchange for promises of money far in the future. The long delay in repayment magnifies the two basic problems of lending in capital market:

1. **It increases risk**: the longer the time to repayment the greater the opportunity for the borrower to misbehave.
2. **It reduces liquidity**: the longer the time to repayment the less important is repayment itself as sources of liquidity.

These two problems are important and basic in dealing in capital markets.

The backbone of the capital market is formed by various securities exchange market that provides a forum for equity (equity/stock market) and debt (debt market) transactions. That is, the capital market includes the stock market (equity securities) and the debt market (debt securities). Mechanisms for efficiently offering and trading securities contribute to the functioning of capital markets which is important to the long-term growth of business. Financial regulators oversee the capital markets in their designated jurisdictions to ensure that investors are protected against fraud, among other duties.

Capital markets consist of the primary market and the secondary market. The primary markets are where new stock and bonds issues are sold (via underwriting) to investors. The secondary

markets are where existing securities are sold and bought from one investor or trader to another, usually on a securities exchange, over the counter, or elsewhere.

Dear leaner, what are the purposes of capital market?

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Purpose of capital market:

- ✓ Promotes a culture of thrift or savings
- ✓ mobilizes long-term savings to finance investment
- ✓ To provide risk capital in the form of equity or quasi equity to entrepreneurs.
- ✓ To encourage broader ownership of productive assets
- ✓ Improves access to finance of different types of users by providing flexibility for customization.
- ✓ To improve the efficiency of capital allocation through a competitive pricing mechanism.
- ✓ Provides investors with efficient mechanism to liquidate their investments in securities.

Money market Vs capital market

Money Market	Capital Market
- market for short term fund	- market for long term funds
- deal with debt securities	- deal with equity securities
- have low risk and low return	- have high risk and high return
- low speculation due to short maturity	- high speculation due to long maturity

Capital market Instruments include:

1) Stocks
2) Mortgages loans
3) Corporate bonds
4) Government bonds
5) Government Agency Securities
6) Foreign bonds
7) A Eurobond
8) Derivative products

Here, we will see the bond and stock market.

3.8.1 Bond market

Dear leaner, what do you understand about bond market? And what is bond? Can you list their differences from Treasury bill?

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BONDS are long-term debt obligations of companies or governments to fund long-term investments in long-term assets, e.g., capital expenditure projects (property, plant, equipment, real estate, highways, etc.). Bond issuers promise to pay face value ($1000) on maturity, and periodic coupon/interest payments: PMT = Coupon Rate (%) x Face Value ($1000).

Bond Markets are markets in which bonds are issued and traded. Bond market traditionally classified into three types (1) treasury notes and bonds (2) municipal bonds (3) corporate bonds. In this section we look at the characteristics of the various bond securities, their trading process, the participants in the bond market and the international bond market.

a) Treasury notes and bonds

T-Bills: One-year maturity or less. Sold on a discount from face value basis, like a zero coupon.

T-Notes: 1-10 year original maturity, semi-annual coupons in most cases.

T-Bonds: 10-30 year original maturity, semi-annual coupons in most cases. **Two types:** 1) Fixed nominal coupon rate bonds with fixed principal, and 2) Inflation-indexed bonds, fixed real rate with an adjustment of actual inflation for coupons and principal.

Treasury notes and bonds are issued by the government treasury to finance the national debt and other federal government expenditures. Like T-bills, T-notes and bonds are backed by the full faith and credit of the federal government and are therefore default risk free. As result, t-notes and bonds pay relatively low rates of interest (yield to maturity) to investors. T-notes and bonds, however, are not completely risk free. Given their longer maturity (i.e duration) these instruments experience wider price fluctuation than do money market instruments as interest rate changes.

Accrued interest - When coupon bonds are sold, they usually have some Accrued Interest, the interest accrued from the time between the last coupon payment, and the current sale date. Thus, buyers of T-notes and bonds must pay the seller the purchase price plus accrued interest. The sum of this often called the full price or dirty price of the security. The price without the accrued interest added on is called clean price.

Accrued interest is computed based on the actual number of days the bond was held by the seller since the last coupon payment.

$$\textit{Accrued interest} = \frac{INT}{2} \times \frac{\textit{Actual number of days since last coupon payment}}{\textit{Actual number of days in coupon period}}$$

Example: assume on August 4, 2008 bond holder sells the bond. 81 days have passed since the last coupon payment on May 15, 2008, and there are 103 days until the next payment, November 15. 2008 and there are 184 days in the entire period between coupon payments and coupon rate is 5.875%.

Accrued interest = (5.875% / 2) x (81 / 184) = 1.29314%.

Note: Semi-annual interest is 5.875%/2 or 2.9375% for 6 months.

On August 4, it is 44.0217% (81/184) of way through the 184 day period, so the bond buyer would pay 1.29314% (.440217 x 2.9375%) of the face value to the bond seller. Current price quoted is 101.34375%. The accrued interest of 1.29314% is added to the quoted "clean" price of 101.34375%, to get 102.63689% or $10,263.689 per $10,000 face value for the actual sale price of the bond (including accrued interest).

Primary and secondary market trading to Treasury notes and bonds;

Similar to primary market T-bill sales, the government sells T-notes and T-bonds through competitive and noncompetitive treasury auctions. Bids are submitted reserve (national) bank and can be competitive or noncompetitive (no price quoted, you agree to accept the weighted average price paid by winning competitive bidders).

Secondary Treasury Market – most secondary market trading for treasury notes and bonds occurs through a network of brokers and dealers.

b) Municipal Bonds

State and local governments (cities, counties, schools, etc.) bonds issued to fund long-term projects like schools, roads, subways, stadiums, etc. Payment is made with taxes or revenues generated (toll road, user fees for subways or stadiums, etc.). Most municipal bonds have favorable tax treatment; interest income (not capital gains) is exempt from state and federal taxes. Corporate bonds are fully taxable; Treasury bonds are taxable at the federal level, exempt at the state level. YTMs are lower for municipals, investors pay more, receive lower YTMs, because of the favorable tax treatment.

Two types of municipal bonds exist: general obligation bonds and revenue bonds

General Obligation (GO) Bonds: No specific assets or collateral, no specific source of revenue, but government unit promises to pay using all resources and taxes, makes a blanket or general obligation to pay. Usually requires taxpayer approval in referendum vote. Because of this requirement and taxpayers reluctance to have their taxes increased, general obligation bonds represent a smaller portion of municipal bonds issued.

Revenue Bonds- have a specific source of revenue identified to pay for bonds: Toll booths, user fees, etc. They are sold to finance a specific revenue generating project and are backed by cash flows from that project. If revenue falls short, bonds go into default. Revenue bonds are therefore riskier than GO bonds.

Municipal bonds pay semi-annual interest, sold in denominations of 5000 usually. Although trading in these bonds is less active than that treasury bonds, a secondary market exists for municipal bonds. Municipal bonds can go into default, during recession as the state and local government units are limited to their tax and revenue base as source of funds for repayment.

Underwriting(trading) Process for Municipal bonds:

The initial(primary market) sale for municipal bonds (and corporate bonds, discussed below) occurs either through a public offering using an investment bank serving as a security underwriter, or through a private placement to small group of investors(usually financial institutions).

Firm Commitment: Investment bank guarantees a firm price for the entire issue, and then sells the bonds to the public at a higher price. Investment bank takes the risk that it may not be able to resell the securities to investors at higher price.

Some municipal (and corporate) securities are offered on **Best Efforts basis**: Investment bank does not guarantee a price, just offers to sell at the market price for a fee. No risk to investment bank for best efforts underwriting. Investors are often more skeptical of best efforts, won't pay as much as Firm Commitment issue.

Private Placement: Sell the entire issue to a large institutional buyer (pension fund, private foundation, etc.) or a group of buyers. Privately placed securities are generally less liquid, compared to public placement since only the largest financial institutions or institutional investors being able or willing to buy and hold them in the absence of an active secondary market. Issuers of privately placed bonds tend to be less well known. As result of lack of information on these issues and the resulting possibility of greater risk, interest rates paid to holders of privately placed bonds tend to be higher than publicly placed bond issues.

C) Corporate Bonds

Corporate bonds are Long-term bonds issued by corporations. . Generally coupon bonds, semi-annual interest, 1000 face value.

Bond Indenture is the legal document that outlines the terms, conditions and **covenants** of the bond issue. Rights and obligations of the bond issuer and the bondholder, e.g., dividend restrictions, call feature, put feature, sinking fund, etc.

3.8.1.1 Bond Characteristics

Bearer Bonds (unregistered) where coupons are attached to bond certificate, vs. **Registered Bonds** where ownership is recorded by name or serial number, payments get paid electronically (most common in the U.S.).

Term bonds have a single maturity date for entire issue vs. **Serial bonds** have several or many maturity dates, with a portion of the issue being paid off on each date.

Mortgage Bonds is secured debt, where specific real estate property has been pledged as collateral. Most corporate bonds are unsecured (debentures) and pay higher yields compared to mortgage bonds.

Subordinated Debt is junior to more senior debt, in some order of priority for payment (secured debt is higher priority than unsecured debt).

Convertible Bonds are convertible to another security of the issuing firm (e.g. common stock) at a predetermined rate, at the discretion of the bond holders. e.g., 330 shares per $1000 bond at a time when the stock is selling for around $3. Bondholders have a valuable option that allows them to become a shareholder if the stock price rises, and they will pay a premium and accept a lower yield. So the market value of the convertible bond will increase as the conversion security price rises. Conversion is an attractive option or feature to bond holders. Thus the yield on convertible bond is usually lower than that on convertible bond.

Stock Warrants (call options) are similar to convertible bonds, but allows the investor to buy shares of stock at a predetermined price on or before a specified date, without giving up the bonds. Stock warrants can also be detached and sold.

Callable Bonds can be called in at the option of the issuer at a predetermined call price, usually at a premium, after a deferred period, e.g. ten years. The closer to maturity, the lower the call premium. Callable bonds have yields higher than non callable bonds.

Sinking Fund Provision of a bond requires the corporation to put funds into an interest-earning escrow account/fund that will be used to pay off the principal of the bonds upon maturity. Sinking fund provision can also be a provision that requires the company to retire bonds early, either by

secondary market purchases or by randomly calling in bonds early. Bonds with a sinking fund are less risky, could be issued at a lower YTM.

Secondary Market for corporate bonds takes place mostly OTC through an inter-dealer network of bond traders, e.g., investment banks. Some bonds also trade on organized exchanges.

3.8.1.2 Bond Ratings

Without credit rating agencies, bond markets and credit markets might not develop, or would be very thin. Information about creditworthiness would be costly for individual or small investors. For example in US Standard and Poor's and Moody's are the two largest bond rating agencies, using 9 letter grades to assign overall credit risk, and then 1, 2, or 3s for Moody's or +/- for S&P. For example, a staff of 1,250 credit analysts, accountants, and economists at S&P conduct research on credit risk for companies, governments, and even countries. Credit analysis involves reviewing the firm's financial statements, conduct financial ratio analysis, consider the bond features including seniority position, etc., and assess credit risk rating for each bond issue.

Top four bond ratings are considered **investment grade**, bottom five are **speculative grade or** junk bonds. Some FIs are restricted to owning only investment grade bonds.

3.8.1.3 Bond Market Participants

Bond issuers (bond supply) are firms and governments. Bond buyers/investors (bond demand) are households, businesses, government units and foreign investors. Note: 1) For municipal bonds and corporate bonds, the largest buyers are **"business financial"** firms (FIs like banks, insurance companies and mutual funds) representing "indirect finance," about in both markets. 2) Foreign investors are investing on Treasuries and corporate bonds. Why no foreigners in municipal bond mkt.?

3.8.1.4 International Bond Markets

a) **Eurobonds** are long-term bonds issued in a foreign country, but not in the domestic currency of the country where they are issued, e.g. dollar-denominated bonds issued outside the U.S. (Europe,

Asia, etc.). Or it could be Yen-denominated bonds issued outside of Japan, in the U.S. or Europe. Notice that it doesn't have to strictly be "Europe."

Eurobonds: 1) are bearer bonds, 2) pay interest annually, 3) are sold in amounts of 5,000 and 10,000, 4) trade OTC, 5) are rated by raters such as Moody's and S&P, and 6) initially sold/underwritten by investment banks.

b) Foreign Bonds are long-term bonds issued in a foreign country, in the domestic currency of the foreign country, e.g. IBM or GM issues bonds in the U.K. denominated in pounds or bonds in Germany in euro. Honda or Toyota issue bonds in the U.S. in dollars.

Note: 1) The three bond markets (Domestic, Foreign and Eurobond) compete with each other, and 2) the international bond market has historically been less regulated and more competitive than the domestic bond market.

3.6 Check Your Progress

1-What is the purpose of capital market?

2-What is the main difference between capital and money market?

3-How do you think a bond is rated?

3.8.2 STOCK MARKETS

Dear learner, what do you understand by stock market?

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Maybe some of us are familiar with the term "Stock exchange" or "Stock market" from news papers, other forms of mass media or from any other information sources. For those who have taken basic courses in Economics or Business, it would be very familiar. At any rate, let me start from the simplest idea. What are stocks?

To begin with the definition, stocks are equity claims on net income and assets of a corporation. To make clear the concept of equity let us put the equity this way. Equities are interests in, claims

upon, assets. Stocks, in the context of this topic, refer to particularly corporate stocks which are one of the principal capital market instruments. A capital market is designed to finance long-term investments, but not short-term investments, by businesses, government and households. Business can start a new or expand by obtaining funds directly from households. One way to do so is by selling stock to the public.

Thus, corporate stocks serve as one source of financing in addition to debt financing and retained earnings financing. Shareholders become owners and are entitled to dividends.

Shareholders are **residual claimants**, and have a claim on the residual income (dividends) and residual assets if firm's is liquidated or dissolved. Residual = left-over. Shareholders are owners, vs. bondholders (creditors, fixed return), and have voting rights to elect the board of directors.
Secondary markets for stocks (NYSE, AMEX, NASDAQ) are closely watched daily. Reasons: a) stock price movements reflect current state of the economy, and predict future economic activity (leading indicator), and b) shares prices also affect the wealth of households and their consumption. Corporate stocks may be the most widely held of all financial securities.

Stock Market Securities are either a) common stock or b) preferred stock. Stock return (or yield) is calculated as follows, from time period *t* (when you buy the stock) to time period ***t + 1*:**

1. **Capital Gain** (**Loss**) as a %: $(P_{t+1} - P_t) / P_t$, which is equal to $\Delta P / P_t$
   or the Change in Price, divided by the original price.
2. **Dividend Yield** (%): D_{t+1} / P_t
3. **Total % Return (R)**: Capital Gain (%) + Dividend Yield (%).

$$R = \Delta P / P_t + D_{t+1} / P_t$$

Example: suppose you owned a stock over the last year. You originally bought the stock for $50 and just sold it for $58. The stock also paid an annual dividend of $ 5 on the last day of the year. Your return on the stock investment can be calculated as follows:

$$\mathbf{R} = \frac{\$58 - \$50 + \$5}{\$50} = \mathbf{26}\ \%$$

a. Common stock is the principal way that corporations raise equity capital. Holders of common stock own an interest in the corporation consistent with the percentage of outstanding shares owned. This ownership interest gives stockholders—those who hold stock in a corporation—a bundle of rights. The most important are the right to vote and to be the residual claimant of all funds flowing into the firm (known as cash flows), meaning that the stockholder receives whatever remains after all other claims against the firm's assets have been satisfied. Stockholders are paid dividends from the net earnings of the corporation. Dividends are payments made periodically to stockholders. The board of directors of the firm sets the level of the dividend, usually upon the recommendation of management. In addition, the stockholder has the right to sell the stock.

Equity (common stock) valuation

One basic principle of finance is that the value of any investment is found by computing the value today of all cash flows the investment will generate over its life. For example, a commercial building will sell for a price that reflects the net cash flows (rents – expenses) it is projected to have over its useful life. Similarly, we value common stock as the value in today's dollars of all future cash flows. The cash flows a stockholder might earn from stock are dividends, the sales price, or both. To develop the theory of stock valuation, we begin with the simplest possible scenario: You buy the stock, hold it for one period to get a dividend, and then sell the stock. We call this the *one-period valuation model*.

i- One –period valuation model

Suppose that you have some extra money to invest for one year. After a year, you will need to sell your investment to pay tuition. After watching *Wall Street Week* on TV, you decide that you want to buy Intel Corp. stock. You call your broker and find that Intel is currently selling for $50 per share and pays $0.16 per year in dividends. The analyst on *Wall Street Week* predicts that the stock will be selling for $60 in one year. Should you buy this stock?

To answer this question, you need to determine whether the current price accurately reflects the analyst's forecast. To value the stock today, you need to find the present discounted value of the expected cash flows (future payments). Note that the discount factor used to discount the cash flows is the required return on investments in equity rather than the interest rate. The cash flows

consist of one dividend payment plus a final sales price. When these cash flows are discounted back to the present, the following equation computes the current price of the stock:

(1) $$Po = \frac{Div_1}{(1+r)} + \frac{P_1}{(1+r)}$$

Where *P*0=the current price of the stock. The zero subscript refers to time period zero, or the present.

*Div*1 = the dividend paid at the end of year 1.

r=the required return on investments in equity.

*P*1=the price at the end of the first period; the assumed sales price of the stock.

To see how the Equation works, let's compute the price of the Intel stock if, after careful consideration, you decide that you would be satisfied to earn a 12% return on the investment. If you have decided that *r* = 0.12, are told that Intel pays $0.16 per year in dividends (*Div*1 = 0.16), and forecast the share price of $60 for next year (*P*1= $60), you get the following from the Equation:

$$P0 = \frac{0.16}{1+0.12} + \frac{\$60}{1+0.12} = \$0.14 + \$53.57 = \$53.71$$

Based on your analysis, you find that the present value of all cash flows from the stock is $53.71. Because the stock is currently priced at $50 per share, you would choose to buy it. However, you should be aware that the stock may be selling for less than $53.71, because other investors place a different risk on the cash flows or estimate the cash flows to be less than you do.

ii-The generalized dividend valuation model

Using the same concept, the one-period dividend valuation model can be extended to any number of periods: The value of stock is the present value of all future cash flows. The only cash flows that an investor will receive are dividends and a final sales price when the stock is ultimately sold in period *n*. The generalized multi-period formula for stock valuation can be written as:

(2) $$Po = \frac{D_1}{(1+r)^1} + \frac{D2}{(1+r)^2} \ldots\ldots\ldots\ldots \frac{Dn}{(1+r)^n} + \frac{Pn}{(1+r)^n}$$

If you tried to use Equation 2 to find the value of a share of stock, you would soon realize that you must first estimate the value the stock will have at some point in the future before you can estimate its value today. In other words, you must find *Pn* in order to find *P*0. However, if *Pn* is far in the future, it will not affect *P*0. For example, the present value of a share of stock that sells for $50 seventy-five years from now using a 12% discount rate is just one cent [$50/(1.1275)=$0.01]. This reasoning implies that the current value of a share of stock can be calculated as simply the present value of the future dividend stream. The **generalized dividend model** is rewritten in Equation 3 without the final sales price:

(3) $P_o = \sum D_t / (1 + r)^t$

Consider the implications of Equation 3 for a moment. The generalized dividend model says that the price of stock is determined only by the present value of the dividends and that nothing else matters. Many stocks do not pay dividends, so how is it that these stocks have value? *Buyers of the stock expect that the firm will pay dividends someday.* Most of the time a firm institutes dividends as soon as it has completed the rapid growth phase of its life cycle.

The generalized dividend valuation model requires that we compute the present value of an infinite stream of dividends, a process that could be difficult, to say the least. Therefore, simplified models have been developed to make the calculations easier. One such model is the **Gordon growth model**, which assumes constant dividend growth.

iii) Gordon (constant dividend) growth model

Many firms strive to increase their dividends at a constant rate each year. Equation 4 rewrites reflect this constant growth in dividends:

(4) $$P_t = \frac{D_0 (1 + g)}{r - g} = \frac{D_1}{r - g}$$

Where *D*0=the most recent dividend paid

g=the expected constant growth rate in dividends

r=the required return on an investment in equity

This model is useful for finding the value of stock, given a few assumptions:

1. *Dividends are assumed to continue growing at a constant rate forever.* Actually, as long as they are expected to grow at a constant rate for an extended period of time, the model should yield reasonable results. This is because errors about distant cash flows become small when discounted to the present.

2. *The growth rate is assumed to be less than the required return on equity, r.* Myron Gordon, in his development of the model, demonstrated that this is a reasonable assumption. In theory, if the growth rate were faster than the rate demanded by holders of the firm's equity, in the long run t Stock price is equal the present value of future dividends (D).

Characteristics of common stock

There are many characteristics of common stock that differentiate it from other types of financial securities such as bonds, mortgages and preferred stock. These include (1) discretionary dividend payments, (2) residual claim status (3) limited liability and (4) voting rights.

Dividends are payments to shareholders as a return on investment, but are not fixed or guaranteed. Paid out of NIAT. Tax disadvantage to dividends: Unlike interest payments, Dividends are not tax-deductible to the firm. Therefore the firm must pay corporate taxes on earnings, and the dividends distributed to shareholders are taxed again as ordinary income for the shareholders. Interest payments are tax-deductible to the firm, so are only taxed ONCE, at the individual level.

Example: $1000 of debt vs. $1000 equity capital, payments of 10% to both investors. $100 of interest is tax-deductible for the firm, but the $100 of dividends is not tax-deductible.

Also, capital gains have preferential tax treatment (lower than the ordinary income tax rate) compared to dividend or interest income. Therefore, it might be to an investor's advantage to NOT get dividend income but get capital gains.

Residual claim – common stockholders have the lowest priority claim on corporation's assets in the event of bankruptcy –they have a residual claim.

Limited Liability is important feature of common stock. Liability of shareholder is limited to initial investment.

Voting rights – a fundamental privilege assigned to common stock is voting right. To exercise control on the business affairs (indirectly) by electing of the board of directors.

b. Preferred Stock, hybrid security of debt (pays fixed interest payments quarterly, e.g. 5%) and equity (ownership interest). Preferred stock is senior to common stock (preferred stockholders get paid first), but junior to debt and bondholders. Dividends on preferred stock are generally fixed and are expressed either as a fixed money amount or a percent of the face value of the preferred stock. Preferred

3.9 Primary Markets vs. Secondary Markets.

Dear learner, from previous discussion made on the previous chapters, can you list the difference between primary and secondary market?

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3.9.1 Primary market:

Firms raise new capital in a primary market transaction by issuing new securities (stocks or bonds) ONCE, and these securities subsequently trade in the secondary market FOREVER. Initial public offering (IPO) is stock issued for the very first time to the public when a company "goes public."

Preemptive rights on issuance of additional share allows existing investors to maintain their ownership position (as a percentage) when new stock is issued. Without this right investors would have their ownership interest diluted.

Rights offering allow existing stockholders to buy additional shares in the company at a subscription price that is generally lower than the market price. Rational stock holders will either exercise the right or sell it (those who let it expire will find out that the market value of their remaining holding shrinks-the market price will almost certainly drop when the rights are exercised since the subscription price is much lower than the market price.

3.9.2 Secondary Market

It is a market in which stocks once issued are traded –that is bought and sold by investors. For example in US it include **the New York stock Exchange (NYSE), National Association of securities Dealers Automated Quotation (**NASDAQ) and American Stock Exchange (**AMEX)**.

Market Structure:

Secondary market for equity serves two purposes:

1. Marketability - Allows buyers in the primary market (IPO) to subsequently sell shares. Would be hard to sell stock in primary market if there wasn't a secondary market.

2. Share price valuation - Active trading in secondary markets establishes a true fair market value of stock.

Secondary Markets are set up as either:

1. Dealer Market - OTC, dealer network, like NASDAQ, where about 450 dealers ("market makers") specialize in buying/selling certain stocks. You are buying (selling) the stock from (to) the dealer, not from (to) another investor, who holds the stock in his/her account. Bid (dealer buys)- Ask (dealer sells) Spread is the dealer's commission, e.g., $5(bid)-$5.05(ask), 1% spread.

Market is very competitive market; thus the spreads could be very lower. No limits on the number of dealers/market makers for a certain stock, and no limit on the number of stocks a dealer can trade.

NASDAQ trading process: Investor uses stock broker, or uses the Internet, contact is made with a NASDAQ dealer to buy/sell DELL, the dealer gets quotes from all DELL dealers, and finds the best price. Only quotations are automated, actual trades do not take place through the computer system, but require direct contact between the dealer and a broker.

2. Agency Market - like NYSE, AMEX. **AMEX and NYSE** are organized as "floor-broker / specialist-market-maker" centralized trading systems, where face-to-face trading takes place at a physical location/trading floor. The broker takes a buy (sell) order from a client/investor/trader, and matches it with a sell (buy) order from another client/trader. More of an auction market.

3. Another system is the **Fully Automated Trading system,** common in Toronto, New Zealand, Australia, etc. where trading is completely automated. Similar to NASDAQ, but quotations and trading takes place directly by computer. Orders are filled faster, and there is very few people are needed to operate an exchange.

Choice of Market Listing. NYSE has the strictest listing requirements, followed by AMEX and NASDAQ. Therefore, NYSE tends to dominated by larger, older, more established firms, and AMEX/NADSAQ attract younger, smaller firms. . NYSE may have some advantages in terms of greater marketability and publicity for firms, so some firms start on AMEX and NASDAQ as small firms and eventually "graduate" to NYSE as larger firms. Many firms now prefer NASDAQ even as large, established firms, e.g. Microsoft. Also, requirements for releasing and filing financial information is more regulated, stricter for NYSE vs AMEX or NASDAQ.

3.9.3 STOCK MARKET INDEXES

A stock Market Index is composite value of a group of stocks traded on secondary markets. Movements in a stock market index provide investors with information on movements of a broader range of secondary market securities.

a) Dow Jones Industrial Average (DJIA) - most widely reported stock market index, include 30 large (in terms of sales and assets) corporations stocks, more than 100 years old. Criteria: Large, stable, "blue-chip," mature firms like IBM, Wal-Mart, Disney, McDonalds, etc. Microsoft and Intel (1999) were the first non-NYSE (NASDAQ) stocks to be added to DJIA. DJ also has indexes for transportation stocks (20 total - FedEx, UPS, Delta Airlines, NWA, CSX railroad), utilities (15) and the DJ composite (65).

Dow indexes are *"price-weighted averages,"* not adjusted for market value of each stock. Closing prices are added up daily, and divided by an adjusted value, or divisor. Prices range from $20 (H-

P) to $88 (IBM). If each stock changes by 10% ($2 for H-P and $8.80 for IBM), IBM will have a greater effect on the DJIA index.

b) NYSE Composite Index - started in 1966 by NYSE to track the overall market of all NYSE stocks. NYSE also calculates indexes for industrials, transportation, utilities and financials. NYSE calculate *"value-weighted indexes,"* meaning that the contribution of each company is weighted by its relative size or market value (P x shares), so that larger companies get more weight than smaller companies.

c) S&P 500 Index includes the 500 largest U.S. firms traded on NYSE and NASDAQ (large-cap index). The NYSE stocks in S&P 500 account for 80% of total NYSE stock market value. S&P 500 dates back to 1923 when it had 233 companies, was expanded in 1957 to include 500 stocks. S&P 500 is maintained by the S&P Index Committee, a group of economists and analysts at S&P. Also, S&P has Global Index, and country-specific stock indexes.

d) NASDAQ Composite Index includes the 4000 NASDAQ stocks, and NASDAQ also has about a dozen other indexes mostly sectors indexes - computers, banks, biotechnology, telecommunications, finance, etc., as well as NASDAQ 100 (largest NASDAQ stocks) and a NASDAQ social index for 180 "Socially responsible firms."

e) MSCI - Morgan Stanley Capital International issues a monthly publication of stock market data/indexes for 24 developed countries, along with a world index. MSCI is also reported daily in the WSJ - country indexes and a world index of 2,600 stocks from 23 countries. Indexes represent at least 60% of market capitalization in each country, and are market-value weighted. MSCI also releases: 1) Regional indexes: a) EAFE = Europe, Australia, and Far East (World - N. America), b) North America (U.S. and Canada), 2) Industry Indexes (dozens), 3) 27 Emerging Market country indexes, and 4) Regional Emerging Markets indexes.

Uses of Indexes

1. Overall market performance
2. Sector performance

3. International Market Performance

3.9.4 International Issues

a)Global 24 hour trading. Ten major stock markets (NYSE, Australia, Tokyo, Hong Kong, Sao Paulo-Brazil, Mexico, Toronto, Amsterdam, Brussels and Paris) started discussions in 2,000 GC and announced the formation of the **Global Equity Market (GEM)**, which will link the major global stock exchanges for 24 hour trading of stocks. Advantages of GEM: Increased liquidity, increased efficiency, greater and easier access to world markets, increased diversification opportunities. Start of GEM has been delayed, pending further discussions on market integration, settlement and clearing procedures, etc.

Notice: 1) U.S. had 60% of world stock market value in 1988, increase from 29% in 1888. International stocks offer investors the opportunity to diversify internationally, and reduce risk below the level of an exclusively domestic portfolio. For example you own one share of U.S. Company and one share of U.K. Company. The U.S. stock declines by -1% during a period when the U.K. stock increases by 15.91% (in dollar terms), resulting in a positive return of +7.46% (.50 x -1.00) + (.50 x 15.91%) = 7.46%.

b) Trading In International Equities

Today, there has been increased global integration of world equity markets due to:

1. Investors seeking international portfolio diversification.
2. Increased capital mobility. Barriers to intl. capital flows (elimination of fixed commissions, deregulation of financial markets, etc.) have been reduced. Introduction of Euro has integrated European financial markets.
3. Advances in Information Technology have facilitated capital flows, research and intl. investing.
4. MNCs have expanded global operations, and have taken advantage of global capital markets.

c) Cross-Listing of Shares is when a firm (MNC) lists/sells its shares on one or more foreign exchanges in addition to the domestic exchange. *Example:* GM might list on NYSE, and on the

exchanges in London and Paris. Honda, Toyota and Yamaha list on the NYSE, in addition to Tokyo.

Why Cross-List?

1. Increased liquidity, broader investor base. Increased global demand may support a higher stock price.
2. Cross-listing improves name recognition globally in new capital markets. May make it easier in future to raise additional equity or debt capital globally, get a higher price for stock, lower interest rate for debt.
3. Company may benefit as more consumers and investors become familiar with the company and it products. Consumers who like the company's products may be more likely to invest in the company, and investors in the company may be more likely to become consumers of the company's products. Nike customers may buy Nike stock, and Nike investors may buy Nike products.
4. May make it harder for an unwanted, hostile takeover due to the diversified, global stockholder base. Advantage or Disadvantage?

Cross-listing requires a MNC to conform to securities laws in both countries.

3.6 Check Your Progress

1-Write the reason for having cross listing?

2-list the various stock index which provide investors with information on movements of a broader range of secondary market securities?

3-Write the assumption for one –period valuation model, The generalized dividend valuation model, Gordon (constant dividend) growth model ?

3.10 Asymmetric Information in Financial Markets

Dear learner, what do you understand by asymmetric information in financial markets?

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Asymmetric information in a market for goods, services, or financial assets refers to differences ("asymmetries") between the information available to buyers and the information available to sellers. For example, in markets for financial assets, asymmetric information may arise between lenders (buyers of financial assets) and borrowers (sellers of financial assets).

In financial markets, one party often does not know enough about the other party to make accurate decisions. This inequality is called asymmetric information. For example, a borrower who takes out a loan usually has better information about the potential returns and risk associated with the investment projects for which the funds are earmarked than the lender does. Lack of information creates problems in the financial system on two fronts: before the transaction is entered into and after.

Problems arising in markets due to asymmetric information are typically divided into two basic types: "adverse selection;" and "moral hazard." This section explains these two types of problems, using financial markets for concrete illustration.

1. Adverse Selection

Adverse selection is a problem that arises for a buyer of a good, service, or asset when the buyer has difficulty in assessing the quality of this item in advance of purchase. Buyers might then offer to buy the item at a price equal to the average (expected) quality of the item. But this encourages sellers of high-quality items to EXIT the market and sellers of low-quality items to ENTER the market, lowering the average quality of items for sale.

Consequently, adverse selection is a problem that arises because of different ("asymmetric") information between a buyer and a seller before any purchase agreement takes place.

In more elaborated manner, adverse selection is the problem created by asymmetric information *before* the transaction occurs. Adverse selection in financial markets occurs when the potential borrowers who are the most likely to produce an undesirable (*adverse*) outcome—the bad credit risks—are the ones who most actively seek out a loan and are thus most likely to be selected. Because adverse selection makes it more likely that loans might be made to bad credit risks,

lenders may decide not to make any loans even though there are good credit risks in the marketplace.

To understand why adverse selection occurs, suppose that you have two aunts to whom you might make a loan—Aunt Liya and Aunt Sebele. Aunt Liya is a conservative type who borrows only when she has an investment she is quite sure will pay off. Aunt Sebele, by contrast, is an inveterate gambler who has just come across a get-rich-quick scheme that will make her a millionaire if she can just borrow Br.1,000 to invest in it. Unfortunately, as with most get-rich-quick schemes, there is a high probability that the investment won't pay off and that Aunt Sebele will lose the Br.1,000.

Which of your aunts is more likely to call you to ask for a loan? Aunt Sebele, of course, because she has so much to gain if the investment pays off. You, however, would not want to make a loan to her because there is a high probability that her investment will turn sour and she will be unable to pay you back.

If you knew both your aunts very well—that is, if your information were not asymmetric—you wouldn't have a problem, because you would know that Aunt Sebele is a bad risk and so you would not lend to her. Suppose, though, that you don't know your aunts well. You are more likely to lend to Aunt Sebele than to Aunt Liya because Aunt Sebele would be hounding you for the loan. Because of the possibility of adverse selection, you might decide not to lend to either of your aunts, even though there are times when Aunt Liya, who is an excellent credit risk, might need a loan for a worthwhile investment.

An Illustration of Adverse Selection in Loan Markets:

In the context of a loan market, an adverse selection problem can arise between lenders (i.e., buyers of newly issued financial assets) and borrowers (i.e., sellers of newly issued financial assets). In particular, if a lender sets contractual terms in advance in an attempt to protect himself against the consequences of inadvertently lending to high risk borrowers, these contractual terms might have the perverse effect of encouraging high risk borrowers to self-select INTO the lender's loan applicant pool while at the same time encouraging low risk borrowers to self-select OUT of

this pool. In this case, the lender's pool of loan applicants is adversely affected in the sense that the average quality of borrowers in the pool decreases.

Suppose, for example, that 50% of potential borrowers in the population at large are high risk, in the sense that there is a high probability they would default on their loan payments, and 50% are low risk in the sense that there is a low probability they would default on their loan payments. A banker is willing to loan to high risk borrowers at an 11% interest rate and to low risk borrowers at a 5% interest rate. Thus, the "risk premium" required by the bank is 6%.

Prior to making a loan to any individual, the bank has no way of knowing whether the individual is a high risk or a low risk borrower. However, the bank knows that the two types of individuals (high risk and low risk) are equally represented in the population. Consequently, prior to actually making any loans, the bank concludes there is a 50-50 chance that any given would-be borrower is high risk or low risk. It might therefore seem reasonable to the bank to charge an interest rate that is an average of the rates for high and low risk borrowers, so the bank sets its loan interest rate at 8%.

Unfortunately for the bank, high risk borrowers will view 8% as a great rate since they know the riskiness of their projects actually warrants a higher rate -- indeed, they would be required to pay 11% if the bank knew their true quality. Consequently, high risk borrowers have an incentive to apply for loans from the bank. On the other hand, low risk borrowers will view 8% as an unnecessarily high and costly rate, and they might turn elsewhere for funds or abandon their intended investment projects altogether.

Consequently, although high risk and low risk borrowers are equally represented in the population at large, when the bank offers a loan rate of 8% the percentage of high risk borrowers attracted to the bank's pool of loan applicants will tend to rise above 50% and the percentage of low risk borrowers in this pool will tend to fall below 50%.

Being rational, the bank might be able to predict this eventuality in advance, in which case the bank might conclude it should set an interest rate higher than 8% to compensate for the fact that

more than 50% of its loan applicant pool will be high risk. However, the effect of any such increase will only be to further compound the adverse selection problem, because low risk borrowers will have an additional incentive to select out of the bank's loan applicant pool. Indeed, all low risk borrowers may eventually be driven out of this pool altogether, leaving only high risk borrowers who are each charged a rate of 11%. To the extent that profits could also have been made on low risk borrowers at a rate as low as 5%, the bank will then be missing out on good profit opportunities.

Potential solutions to adverse selection problems in the context of financial markets will be taken up in later parts of the course.

2-Moral Hazard

Dear learner, what is moral hazard?

_____

Moral hazard is said to exist in a market if, after the signing of a purchase agreement between the buyer and seller of a good, service, or financial asset:

- ✓ The seller changes his or her behavior in such a way that the probabilities (risk calculations) used by the buyer to determine the terms of the purchase agreement are no longer accurate;
- ✓ The buyer is only imperfectly able to monitor (observe) this change in the seller's behavior.

For example, a moral hazard problem arises if, after a lender purchases a loan contract from a borrower, the borrower increases the risks originally associated with the loan contract by investing his/ her borrowed funds in more risky projects than s/he originally reported to the lender.

In more precise manner, moral hazard is the problem created by asymmetric information after the transaction occurs. Moral hazard in financial markets is the risk (hazard) that the borrower might engage in activities that are undesirable (immoral) from the lender’s point of view, because they make it less likely that the loan will be paid back. Because moral hazard lowers the probability that the loan will be repaid, lenders may decide that they would rather not make a loan.

As an example of moral hazard, suppose that you made a Br.1,000 loan to another relative, Uncle Melaku, who needs the money to purchase a word processor so he can set up a business typing students' term papers. Once you have made the loan, however, Uncle Melaku is more likely to slip off to the track and play the horses. If he bets on a 20-to-1 long shot and wins with your money, he is able to pay you back your Br. 1,000 and live high off the hog with the remaining Br.19,000. But if he loses, as is likely, you don't get paid back, and all he has lost is his reputation as a reliable, upstanding uncle. Uncle Melvin therefore has an incentive to go to the track because his gains (Br.19,000) if he bets correctly are much greater than the cost to him (his reputation) if he bets incorrectly. If you knew what Uncle Melvin was up to, you would prevent him from going to the track, and he would not be able to increase the moral hazard. However, because it is hard for you to keep informed about his whereabouts— that is, because information is asymmetric—there is a good chance that Uncle Melaku will go to the track and you will not get paid back. The risk of moral hazard might therefore discourage you from making the Br.1,000 loan to Uncle Melaku, even if you were sure that you would be paid back if he used it to set up his business.

The problems created by adverse selection and moral hazard are an important impediment to well-functioning financial markets. Again, financial intermediaries can alleviate these problems.

With financial intermediaries in the economy, small savers can provide their funds to the financial markets by lending these funds to a trustworthy intermediary—say, the Honest John Bank—which in turn lends the funds out either by making loans or by buying securities such as stocks or bonds. Successful financial intermediaries have higher earnings on their investments than small savers, because they are better equipped than individuals to screen out bad credit risks from good ones, thereby reducing losses due to adverse selection. In addition, financial intermediaries have high earnings because they develop expertise in monitoring the parties they lend to, thus reducing losses due to moral hazard. The result is that financial intermediaries can afford to pay lender-savers interest or provide substantial services and still earn a profit.

3.11 Summary

In attempting to characterize the way financial markets operate, one must consider both the various types of financial institutions that participate in such markets and the various ways in which these markets are structured. The role of the financial markets in channeling savings into investment is absolutely essential to the health and vitality of the economy. For example, if households set aside savings and those funds are not returned to the spending stream through investment by business and governments, the economy will begin to contract.

To go over the main points, a financial market is a market where financial assets are exchanged (i.e. traded). Market for financial assets is a market in which funds are transferred from people who have an excess of available funds to people who have a shortage. Financial markets such as bond and stock markets are crucial to promoting greater economic efficiency by channeling funds from people who do not have a productive use for them to those who do, a process that results in greater economic efficiency. The scope and complexity of this market largely depends on the level of development of an economy.

The money market is the market for shorter-term securities, generally those with one year or less remaining to maturity. For examples: Treasury bills; negotiable bank certificates of deposit (CDs); commercial paper, Federal funds; Eurodollars. In finance, the money market is the financial market for short-term borrowing and lending. It provides short-term liquid funding for the financial system.

The capital market is the market for longer-term securities, generally those with more than one year to maturity. For examples: Corporate stocks; residential mortgages; government securities (marketable long-term); state and local government bonds; bank commercial loans; consumer loans; commercial and farm mortgages. Capital market is the market where capital funds debts and equity is traded; includes medium and long term securities; distinct of money market which is for short term investments. The market for long-term funds Instruments are equity and credit market securities with original maturity greater than one year. Credit market securities consist of bonds and bank loans.

Indeed, well-functioning financial markets are a key factor in producing high economic growth, and poorly performing financial markets are one reason that many countries in the world remain desperately poor. Activities in financial markets also have direct effects on personal wealth, the behavior of businesses and consumers, and the cyclical performance of the economy. In short, financial markets not only affects individuals life but also involve huge flows of funds throughout the economy which in turn affects business profits, the production of goods and services and even the economic well being of countries.

Self Assessment Questions 3

Part I- Multiple Questions: Chose the best answer among the alternative given below each questions.

1. Which one of the following is not part of three essential types of markets at work within the economic system?
   - A. Factor markets,
   - B. Financial markets,
   - C. Product market,
   - D. All of the above,
   - E. None of the above
2. Which one of the following statement is/are true about an over-the-counter market?
   - A. Has no centralized mechanism or facility for trading.
   - B. Is a public market consisting of a number of dealers spread across a region, a country, or indeed the world, which make the market in some type of asset.
   - C. The dealers themselves post bid and asked prices for this asset and then stand ready to buy or sell units of this asset with anyone who chooses to trade at these posted prices.
   - D. All of the above,
   - E. None of the above.
3. _____ is typically a public market in the sense that it is open to all agents who wish to participate.
   - A. Product market
   - B. Factor markets
   - C. An auction market
   - D. All of the above,

E. None of the above.

4. All are true about financial products, except;

A) Stocks B) Brokerage firms C) Bonds

D) Mutual funds E) None of the above.

5) Financial intermediaries includes all of the following, except;

c) Mutual funds

d) Banks,

e) Brokerage firms,

f) Insurance companies

g) None of the above.

Part II: Matching

<u>Direction</u>: Match statements under 'Column One' with the correct terms under 'Column Two'

	Part One		**Part Two**
1	Permit buyers and sellers to trade with each other in a centralized location, like an auction.	A	Rights of offering
2	Particular types of securities that require the issuer to pay the holder certain fixed dollar amounts at regularly scheduled intervals until a specified time is reached.	B	A stock market index
3	Serves in the countries where trading is completely automated.	C	Agency Market
4	A commissioned agent of a buyer (or seller) who facilitates trade by locating a seller (or buyer) to complete the desired transaction.	D	Insurance
5	A medium of exchange which ensures the success of exchange by being the one item on offer that is always acceptable.	E	Organized exchanges
6	The price at which a dealer offers to sell an asset.	F	Asked price
7	Composite value of a group of stocks traded on secondary markets.	G	Fully automated trading system

8	Offer investors in the money and capital markets an opportunity to reduce risk.	H	Forward market
9	One in which assets or financial services are traded for immediate delivery.	I	Options markets
10	Allows existing stockholders to buy additional shares in the company at a subscription price that is generally lower than the market price.	J	Money
		K	A broker
		L	Debt instruments
		M	Dealer Market
		N	A spot market
		O	None

Part III: True or False

Direction: Say true or false for the following statements.

1. The money market is a sector of the capital market where temporary obligations such as Treasury bills, commercial paper and bankers' acceptances are bought and sold.
2. The main role of markets in an economic system can be carrying out a task of allocating resources and predicting goods and services.
3. An individual who goes to his or her local banker to secure a loan for a new car enters the open market for auto loans.
4. Investors can obtain news of upcoming shares both on the primary and/or secondary markets.
5. Companies and the Government can raise funds for long-term investments via the money market.

CHAPTER 4: FINANCIAL INSTITUTIONS

4.0 Objectives

After completing this chapter successfully, you should be able to:

- √ Understand the meaning and components of financial system,
- √ Describe the nature and role of financial intermediaries,
- √ Portray activities of commercial banks,
- √ Discuss the characteristics of savings and loan associations, and
- √ Explain the characteristics of credit unions.

4.1 Financial Institutions at a Glance

Dear learner, from discussions made in the previous chapters, what do you understand by financial institutions?

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Financial institutions are those organizations, which are involved in providing various types supervised by the rules and regulations delineated by government authorities. Some of the financial institutions also function as mediators in share markets and debt security markets.

These institutions include: Banks, Stock Brokerage Firms , Non Banking Financial Institutions, Building Societies , Asset Management Firms, Credit Unions and Insurance Companies. Financial institutions deal with various financial activities associated with bonds, debentures, stocks, loans, risk diversification, insurance, hedging, retirement planning, investment, portfolio management, and many other types of related functions.

With the help of their functions, the financial institutions transfer money or funds to various tiers of economy and thus play a significant role in acting upon the domestic and the international economic scenario. For carrying out their business operations, financial institutions implement different types of economic models. They assist their clients and investors to maximize their

profits by rendering appropriate guidance. Financial institutions also impart a wide range of educational programs to educate the investors on the fundamentals of investment and also regarding the valuation of stock, bonds, assets, foreign exchanges, and commodities.

As a general rule what financial intermediaries do is to create assets for savers and liabilities for borrowers which are more attractive to each than would be the case if the parties had to deal with each other directly.

4.2 The role of financial institutions

So, Dear leaner, what do you think is the role of financial institutions?

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The followings are the major role of financial institutions in the economy:

1. Providing payments mechanism: Most transactions made today are not done with cash instead payments are made using checks, credit cards, debit cards and electronic transfers of funds. These methods for making payments are provided by certain financial institutions. Financial institutions perform check clearing and wire transfer services. A debit card differs from a credit card in that in the latter case, a bill is sent to the credit card holder periodically (usually once a month) requiring payments for transactions made. In the past in the case of a debit card, funds are immediately withdrawn (that is, debited) from the purchaser's account at the time the transaction takes place.

2. Maturity transformation: The financial institutions (e.g. banks) perform the valuable functions of converting funds that savers are willing to lend for only short period of time into funds the financial institution themselves are willing to lend to borrowers for longer periods. Maturity transformation function of financial institution has two implications. First, it provides investors with more choices concerning maturity for their investments; borrowing has more choices for the length of their debt obligations. Second, because investors are naturally reluctant to commit funds for a longer period of time, they will require that long-time borrowers pay a higher interest rate than on a short -time borrowing. A financial institution is willing to make long-term loans, and at

a lower cost to the borrower than an individual investor would, by counting on successive deposits providing the funds until maturity. Thus, the second implication is that the cost of long-term borrowing is likely to be reduced.

3. Reducing risk through diversification: Consider the example of an investor who places funds in an investment company. Suppose that the investment company invests the funds received in the stock of a large number of companies. By doing so, the investment company has diversified and reduced its risk. Investors who have a small sum to invest would find it difficult to achieve the same degree of diversification because they don't have sufficient funds to buy shares of a large number of companies. Because financial institutions acquire funds from large numbers of surplus units and provide funds to large numbers of deficit units, substantial diversification is effected and the risk of financial loss is reduced. The diversification is the holding of many (rather than a few) assets reduces risk. Because all assets don't behave in the same way at the same time, therefore, the behavior of one asset will on some occasions cancel out the behavior of another. Financial institutions (intermediaries) also offer the risk reducing benefits of management expertise since they do have a manpower that specializes in credit risk assessment & monitoring of borrowers.

4. Reducing transaction costs : Not only do Financial institutions have a greater incentive to collect information, but also their average cost of collecting relevant information is lower than for individual investor (i.e., information collection enjoys economies of scale). An economy of scale is a concept that cost reduction in trading and other transaction services results from increased efficiency when financial institutions perform these services.

Such economies of scale of information production and collection tend to enhance the advantages to investors of investing via financial institutions rather than directly investing themselves.

4.3 Classification of Financial Institutions

Dear learners! How are you doing? Are we together? I believe yes! Ok, I think by now you may have some hint about the financial institutions in brief. Having it in mind, let us see things, from the grass root level starting from the very classification of the considered institutions. I wish you pleasant study time with us!

Enjoy your reading!!!

Financial institutions are the firms that provide financial services and advices to its clients. The financial institutions are generally regulated by the financial laws of government authority.

Types of Financial Institutions include:

- √ Commercial banks;
- √ Credit unions;
- √ Stock brokerage firms;
- √ Asset management firms;
- √ Insurance companies;
- √ Finance companies;
- √ Building Societies; and
- √ Retailers.

The various financial institutions generally act as the intermediaries between the capital market and debt market. But the service provided by financial institution depends on its type. The financial institutions are also responsible to transfer funds from investors to the companies. Typically, these are the key entities that control the flow of money in the economy. The services provided by the various types of financial institutions may vary from one institution to another.
Financial institutions can also be categorized as deposit taking institutions, and this include: Finance and Insurance Institutions; Investment Institutions; Pension Providing Institutions; and Risk Management Institutions.

At the same time, there are several governmental financial institutions assigned with regulatory and supervisory functions. These institutions have played a distinct role in fulfilling the financial and management needs of different industries, and ave also shaped the national economic scene. Deposits taking financial organizations are known as commercial banks, mutual savings banks, savings associations, and loan associations and so on. The primary functions of financial institutions of this nature are: Accepting Deposits; Providing Commercial Loans; Providing Real Estate Loans; Providing Mortgage Loans; and Issuing Share Certificates.

Finance companies provide loans, business inventory financing and indirect consumer loans. These companies get their funds by issuing bonds and other obligations. These companies operate in a number of countries. On the other hand, there are insurance companies that provide coverage for a

variety of risk factors and they also provide several investment options. Insurance companies provide loans for a number of purposes and create investment products.

4.1 Check Your Progress

1-What are the main issues or instruments or financial contracts or functions within which these firms perform their activities?

2. In most cases, financial institutions are engaged in intermediation. Who are the parties these firms are intermediating?

3. Some financial institutions facilitate the economic activities of different organizations through collecting funds from the investors and direct it to those various financial services providers. Give some exemplar of those institutions engage in such kind of activities.

4.4. Depository Institutions

Dear learner, Can you list the types of depository institutions?

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Depository institutions are financial institutions that raise loan able funds by selling deposits to the public or in other words they are those institutions whose funds come significantly from customer deposits. They accept deposits from individuals and firms and use these funds to participate in the debt market, making loans or purchasing other debt instruments such as Treasury bills.

👍The major types of depository financial institutions are: Commercial banks, Saving and Loan Associations, Mutual Savings Banks, Micro Finance Institutions (MFIs), and Credit Unions.

The major assets of depository institutions are loans (financial assets) and reported on the left hand side of the balance sheet. The major liabilities (sources of funds) of depository institutions are deposits and are presented on the right hand side of the balance sheet.

Depository institutions can also be generally categorized in to commercial banks and other depository institutions (such as saving and loan institutions, credit unions, and microfinance institutions). The following table shows the distinction between commercial banks and other depository institutions:

Distinction between commercial banks and other depository institutions

Area of Difference	Commercial Banks	Other Depository Institutions
Size of Loan	Large	Small
Composition	Diversified and Broader	Few
Liabilities	Include liabilities other than deposits	Principally include deposits
Regulation	Stringent	Not stringent

Depository institutions are popular financial institutions for the following reasons:

1. They offer deposit accounts that can accommodate the amount and liquidity characteristics desired by most surplus units.
2. They repackage funds received from deposits to provide loans of the size & maturity desired by deficit units.
3. They accept the risk on loans provided.
4. They have more expertise than individual surplus units in evaluating the credit worthiness of deficit units.
5. They diversify their loans among numerous deficit units and therefore can absorb defaulted loans better than individual surplus units could.

When a depository institution offers a loan, it is acting as a creditor, just as if it had purchased a debt security. Yet, the more personalized loan agreement is less marketable in the secondary market than a debt security, because detailed provisions on a loan can differ significantly among loans. Any potential investors would need to review all provisions before purchasing loans in the secondary market.

Honorable Learners! How are you doing? Are you acquiring the necessary knowledge? If you are not in a mood take 5 minutes to relax and come back with fresh mind so as to sprint together as per the needed speed. Have you done so? Well go on! A more specific description of each depository institutions role in the financial markets follows:

4.4.1 Commercial Banks

Dear learner, I hope you have a good understanding about commercial banks. Take a lot at on surrounding bank around your village and list what kind of services is offered there?

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Commercial Banks are institutions that offer deposit and credit services as well as a growing list of newer services as investment advice, security underwriting, selling insurance and financial planning. Unlike the name "commercial", commercial banks expanded their services to consumers and Government units to be a financial department store of the financial system.

Commercial Banks manage the customers' current and savings accounts, pay out checks that have been drawn on the bank by account holders, and also perform the collection of checks deposited in their customers' accounts. Banks implement a number of other procedures for payments to customers, such as: ATM's (Automated Teller Machines), telegraphic transfer, and EFTPOS (Electronic Funds Transfer at the Point of Sale), or Debit Cards.

The borrowing process of banks is carried out by receiving funds in savings accounts and current accounts and receiving term deposits, as well as through issuance of debt securities, such as bonds and banknotes. Banks also provide loans to customers that are repayable in installments as well as lending through investments in tradable debt securities and other types of lending. Banks offer a comprehensive variety of payment facilities, and a bank account is regarded as indispensable by the majority of Governments, business enterprises, and individuals.

4.4.1.1 Functions of Commercial Banks

Commercial banks play an indispensable roll in the economic activities of every country. Accordingly, the following are among the main functions of the commercial banks:

- ✓ They process payments with the help of online banking, telegraphic transfer, debit card, and other methods;
- ✓ They issue banknotes, such as promissory notes;
- ✓ Acceptance of funds on term deposits;
- ✓ Issuance of bank checks and bank drafts;

- ✓ Offering performance bonds, guarantees, letters of credit, and other types of documents related to underwriting commitments for securities;
- ✓ Safe custody of important documents and other valuable items in safe deposit vaults or safe deposit boxes;
- ✓ Providing loans through installment loans, overdrafts, and others; and
- ✓ Selling and brokerage services related to unit trust and insurance products and
- ✓ Foreign exchange services.

Correspondingly, commercial banks are business corporations that accept deposits, make loans, and sell other financial services, especially to other business firms, to households and Governments. They are the largest and most important depository institutions. They have the largest and most diverse collection of assets of all depository institutions. Their main source of funds is demand deposits (i.e., checking account deposits) and various types of savings deposits (including time deposits and certificates of deposit).

The major use of funds by commercial banks is making loans. They are assets of the commercial bank. These loans could include real estate loans and loans to businesses & automobile loans. The remaining commercial banks' assets include securities (primarily federal government bonds), vault cash, and deposits at the central bank. Commercial banks also allow for a diversity of deposit accounts, such as checking, savings, and time deposit. These institutions are run to make a profit and owned by a group of individuals.

4.4.1.2 Classification of Commercial Banks

Commercial banks can be classified in different types depending on their activities or as per their functions in the economy. The following classification is the common one.

I. Unit Banking

- ✓ A banking business operating a single banking office
- ✓ All operations housed in a single office

II. Branch Banking

- ✓ A single bank that offers a full-fledged services in two or more offices across the country, including offices abroad
- ✓ Home office is the largest branch in the system

III. Correspondent Banking

- ✓ An arrangement whereby a bank maintains deposit balance with other banks at a distant place for a variety of services and assistance
- ✓ The practice can take place within the local environment among local banks or overseas

Check Your Progress

1. What are the major types of depository financial institutions?
2. What are the primary functions of depository financial institutions?
3. What are the reasons or activities that make depository financial?

Institutions popular/unique?

4.4 1.3 Activities and Services of Commercial Banks

Dear learner, what are the various activities and functions of commercial banks?

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Activities of commercial banks can be too much; however, the following are the main and common activities that are crucial in the economic and commercial system of any country.

A. Loans And Advances

B. Overdraft

C. Deposits Services: Commercial Banks Also Provide Different Types Of deposit ervices. The

Main Ones Are Described In The Following Section:

1. Special Demand Deposit Account
2. Saving Account
3. Fixed (Time) Deposit
4. Current Account
5. Diaspora Account

D. Money Transfers

E. Foreign Currency

F.Guarantee Services

G.Information & Advisory Services

Hello Brothers and Sisters! How is everything? Are things moving as per your plan? Are you performing as you are to be? Are you confident enough by your achievement? Bear in mind that, in the teaching and learning process, you are the master of yourself than anybody else! So, do as best of your level to be the winner of the match!

4.4.2 Other Depository Institutions

Dear learner, can you list other non depository institutions?

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Stable financial institutions are an important component of well-functioning financial Systems, as it has been vividly demonstrated by recent developments around the globe. When banking or, other depository financial institutions temporarily break down or operate ineffectively, the ability of firms to obtain funds necessary for continuing existing projects and pursuing new endeavors is curtailed. Severe disruptions in the intermediation process can even lead to financial crises and, in some cases, undo years of economic and social progress.

The importance of depository institutions for economic growth coupled with their fragility has led governments to establish official agencies to regulate and supervise them. The common goals for these agencies are to promote the development of the modern financial systems that (a) avoid excessive fragility and (b) efficiently intermediate between savers and borrowers. The following are among the other depository institutions (in addition to banks) which play significant role in the economic and financial system of every country.

1. Savings and Loans Associations

A savings and loan association is a financial institution that specializes in accepting savings deposits and making mortgage loans. They are often mutually held (often called mutual savings banks), meaning that the depositors and borrowers are members with voting rights and have the ability to direct the financial and managerial goals of the organization**.**

Savings and loans associations (S&Ls) were originally designed as mutual associations, (i.e., owned by depositors) to convert funds from savings accounts into mortgage loans. They are the predominant home mortgage lender in many countries, making loans to finance the purchase of housing for individuals and families. The purpose is to ensure a market for financing housing loans. Today, the distinction between S&Ls and commercial banks is minimal. However, S &Ls continue to hold a less diversified set of assets than commercial banks do.

S and Ls accept deposit and extend loans primarily to household customers. S and Ls emphasize on longer-term loans to households in contrast of most other deposit type financial institutions. Many S and Ls are mutual and therefore have no stockholders but owned by depositors.

The characteristics of savings and loan associations

The most important purpose of these institutions is to make mortgage loans on residential property. These organizations, which also are known as savings associations, building and loan associations, cooperative banks and homestead associations, are the primary source of financial assistance to a large segment of many countries homeowners. As home-financing institutions, they give primary attention to single-family residences and are equipped to make loans in this area.

Some of the most important characteristics of a savings and loan association are:

1. It is generally a locally owned and privately managed home financing institution.
2. It receives individuals' savings and uses these funds to make long-term amortized loans to home purchasers.
3. It makes loans for the construction, purchase, repair, or refinancing of houses.
4. It is state or federal chartered.

2. Credit Unions

Dear learner, what is the difference between credit union and saving & loan associations?

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Credit Unions are house hold oriented intermediaries, offering deposit and credit services to individuals and families. They are cooperative, self-help association of individuals rather than profit motivated institutions accepting deposits from and making loans to their members, all of whom have a common bond, such as working for the same employer. They offer low loan rates

and high deposit interest rates and have relatively low operating costs. The members of a credit union are owners receiving dividends and sharing in any losses that occur. Credit Unions usually report low default and delinquency rates and organized around a common affiliate.

They are organized as cooperative depository institutions, much like mutual savings banks. Depositors are credited with purchasing shares in the cooperative, which they own and operate. Like savings and loans. Credit unions were originally restricted by law to accepting savings deposits and making consumer loans. Recent regulatory changes allow them to accept checkable deposits and make a broader array of loans.

Credit union policies governing interest rates and other matters are set by a volunteer Board of Directors elected by and from the membership itself. Only a member of a credit union may deposit money with the credit union, or borrow money from it. As such, credit unions have historically marketed themselves as providing superior member service and being committed to helping members improve their financial health.

Credit unions typically pay higher dividend (interest) rates on shares (deposits) and charge lower interest on loans than banks. Credit union revenues (from loans and investments) do, however, need to exceed operating expenses and dividends (interest paid on deposits) in order to maintain capital and solvency. Often credit unions have a lower cost of funds than typical commercial banks, due to a higher proportion of non/low interest bearing deposits.

Credit unions offer many of the same financial services as banks, often using a different terminology. Common services include: share accounts (savings accounts), share draft (checking) accounts, credit cards, share term certificates (certificates of deposit), and online banking.

Credit unions exist in a wide range of sizes, ranging from volunteer operations with a handful of members to institutions with several billion dollars in assets and hundreds of thousands of members.

3. Micro-Finance Institutions

Micro finance is defined as the provision of financial intermediation through distribution of small loans acceptance of small savings and the provision of other financial products and services to the poor. A micro finance institution (MFI) is an organization that offers financial services to the very

poor. They are making small loans available to the poor through schemes specially designed to meet the Poor's particular needs and circumstances. The main focus of micro financing is on the poor through provision of small credit and acceptance of small savings.

Micro-finance clients are typically self-employed, entrepreneurs. In rural areas, they are usually small farmers and others who are engaged in small income generating activities such as food processing and petty trade. In urban areas, micro-finance activities are more diverse and include shopkeepers, service providers, artisans, street vendors, etc.

Types of Services Provided by Micro-Financing Institutions

Credit provision & saving mobilization are the core financial products /services provided by MFIs. But there are other services provided by MFI. Micro financial Institutions provide the Credit provision, Saving mobilization and other types of services:

1. **Credit provision** (Small size credit/loans) **to**:

- ✓ Rural and urban poor households;
- ✓ Petty traders;
- ✓ Handcraft producers;
- ✓ Unemployed youth and women ...etc.

2. **Saving mobilization**

- ✓ One of the objectives of MFIs is to encourage the saving habit of the poor society.

3. **Other services**

Now a day, in addition to credit provision and saving mobilization, some MFIS provide other financial services like local money transfer, insurance and pension fund administration and short-term training to clients.

- ➢ **The Distinguishing characteristics of micro finance from Conventional Banks**

The most distinguishing characteristics of MFIs from the conventional banks are:

1. Procedures are designed to be helpful to the client and therefore are user friendly. They are simple to understand, locally provided and easily and quickly accessible.

2. The traditional lender's requirement for physical collateral (such as land, house and productive assets) is usually replaced by system of collective guarantee groups whose members are mutually responsible for ensuring individual loans are repaid. Loans are dependent not only on individual's repayment performance, but also on that of every other group members.
3. Loan amounts especially at the first loan cycle are too small, much smaller than the traditional banks would find it viable to provide service.
4. Borrowers are usually required to be savers.
5. Together with their long term sustainability they have the objective of ending poverty and
6. MFI's operating costs as well as administrative cost per loan are higher than the conventional bank's.

➢ **Objectives of the Micro finance Institutions**

The goal of MFIs as development organizations is to service the financial needs of un-served or underserved markets (the poor) as a means of meeting development objectives. The development objectives generally include one or more of the following:

- ✓ To reduce poverty.
- ✓ To help existing businesses grow or diversify their activities and to encourage the development of new businesses.
- ✓ To create employment and income opportunities through the creation and expansion of micro enterprise and ,
- ✓ To increase the productivity and income of vulnerable group, especially women and the poor.

4. Mutual Savings Banks

Mutual savings banks are much like savings and loans, but are owned cooperatively by members with a common interest, such as company employees, union members, or congregation members. Saving banks play an active role in the residential mortgage banks but are more diversified in their investments, purchasing corporate bonds and common stocks, making customer loans and investing in commercial mortgage banks. Saving banks are owned by their depositors to which all earnings not retained are paid as owner’s dividend. Mortgage and Mortgage related instruments are principal assets followed by investments in non-mortgage loans, corporate bonds, corporate stocks and government bonds.

5. Money Market Funds

Money Market Funds are financial intermediaries pooling deposits of many individuals and investing those in short-term, high quality, money market instruments. Money fund offer accounts whose yields are free to reflect prevailing interest rates in the money market.

Check Your Progress

1.Enumerate the most important characteristics of savings and loan associations:

2. What is the difference between credit unions and banks? Explain.

3. Identify the beneficiaries of micro financial institutions credit provisions?

4. Who own saving banks? Explain.

4.5 Non-depository Institutions

Dear learner, I hope you have grasped a good idea about depository institutions, so now , what do you think of non depository institutions?

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Unlike depository institutions, non-depository institutions do not accept checkable deposits. With one exception that will be noted shortly, you cannot simply write a "check" to withdraw funds from a non-depository institution.

Types and Role of Non-depository Financial Institutions

Non-depository institutions serve various functions in financial markets, ranging from financial intermediation to selling insurance against risk. The following are some of the types of non-depository financial institutions with their role in the financial system.

A. Financial brokers

Brokerage Houses or firms: buy/sell old securities on behalf of individuals. Brokerage firms serve the valuable function of linking buyers and sellers of financial assets. In this regard, they function as intermediaries, earning a fee for each transaction they create. Modern brokerage firms compete with depository institutions in the deposit market, where they attract depositors with money market mutual funds.

B. Investment Institutions (Finance Companies, Investment Companies and Mutual Funds)

i) Finance Companies: are sometimes called department stores of consumer and business credit. They grant credit to businesses and consumers for a wide variety of purposes acquiring their funds mainly from debt. Like banks, they use people's savings to make loans to businesses, but instead of holding deposits, they sell bonds and commercial papers.

Types of finance companies

√ ***Consumer Finance companies***-make personal cash loans to individuals.

√ ***Sales Finance Companies***- make indirect loans to consumers by purchasing installment paper from dealers selling automobiles and other consumer durables.

√ ***Commercial Finance Companies***- focus primarily on extending credit to business firms.

√ ***Other Financial Institutions:***

- ✓ ***Security Dealers*** are firms that take a position of risk in government and privately issued securities, purchasing the instruments from sellers and reselling them to buyers with the expectation of a profitable spread between purchases and sales.
- ✓ ***Investment Banks*** are capital market firms that assist businesses and governments to issue debt and stock in order to raise new capital.
- ✓ ***Mortgage Banks*** are intermediaries that work with other businesses or real estate development projects and sell the mortgage loan instruments to other investors.
- ✓ ***Venture Capital Firms*** are institutional investors that provide long-term capital financing for new businesses and rapidly emerging companies.
- ✓ ***Real Estate Investment Trusts*** are specialized lenders and equity investors that finance commercial and residential projects.
- ✓ ***Leasing Companies*** are financial firms that purchase business equipment and other productive assets and make the purchased items available for use by others in return for rental fee.

ii) ***Investment companies:*** provide an outlet for the savings of many individual investors towards bonds, stocks, and money market securities. Most investment companies stocks are highly liquid because they repurchase their outstanding shares at current market price.

i) ***Mutual funds:*** are especially attractive to small investor, which purchase shares of these funds and gain greater diversification, risk sharing, lower transaction cost, opportunities for capital gains

and indirect access to higher yielding securities that can be purchased only in large blocks. They pool funds of savers and make them available to business and government demanders.

They obtain funds through sale of shares and uses proceeds to acquire bonds and stocks issued by various business and government units. They create a diversified and professionally managed portfolio of securities to achieve a specified investment objective, such as liquidity with high return. Some mutual funds, called money market mutual funds, invest in short-term, safe assets like Treasury bills and large bank certificates of deposit.

C. Pension Funds

A Pension fund is a pool of assets forming an independent legal entity that are bought with the contributions to a pension plan for the exclusive purpose of financing pension plan benefits. Pension funds are savings plan through which fund participants accumulate savings during their working days so that they withdraw the fund during their retirement years.

A pension plan is a promise by a pension plan sponsor to a plan member to provide a pension upon retirement. The sponsor may be a company, an employer, a union or a jointly trustee plan where both management and unions in an industry appoint trustees to a board which manages the plan. This promise is legally stated in the "pension plan document" which states the provisions for the plan. Pension plans may be regulated by governments or financial institutions.

A trustee is appointed to hold the assets in trust for the benefit of the plan members. Usually the trustee is also the custodian, which holds the plan investments. Pension plans usually hire an outside investment manager to invest the plan assets. The sponsor may also appoint an "investment consultant" to advice on investment issues and help select and assess the performance of investment managers.

D. Insurance

Insurance can be defined from the view points of the individual and the society. From an individual point of view insurance is an economic device whereby the individual substitutes a small certain cost (the premium) for a large uncertain financial loss (the contingency insured against) that would exist if it were not for the insurance. Insurance is the protection against financial loss. ***The creation of the counterpart of risk is the primary function of insurance.***

Insurance doesn't decrease the uncertainty for the individual as to whether the event will occur, nor does it alter the probability of occurrence, but it does reduce the probability of financial loss concerned with the event.

From the viewpoint of the society, insurance is an economic device for reducing and eliminating risk through the process of combining a sufficient number of homogenous exposures into a group to make the losses predictable for the group as a whole. From the viewpoint of the insured, insurance is a transfer device. From the viewpoint of the insurer, insurance is a retention and combination device. The distinctive feature of insurance as a transfer device is that it involves some pooling of risks; i.e., the insurer combines the risks of many insured. ***Insurance does not prevent losses, nor does it reduce the cost of losses to the economy as a whole.*** The existence of insurance encourages some losses for the purpose of defrauding the insurer, and in addition, people are less careful and may exert less effort to prevent losses than they might if the insurer did not exist.

E. Investment Banking Firms

Investment is the commitment of money or capital to purchase financial instruments or other assets in order to gain profitable returns in the form of interest, income, or appreciation of the value of the instrument. Investment is related to saving or deferring consumption.

An investment involves the choice by an individual or an organization such as a pension fund, after some analysis or thought, to place or lend money in a vehicle, instrument or asset, such as property, commodity, stock, bond, financial derivatives (e.g. futures or options), or the foreign asset denominated in foreign currency, that has certain level of risk and provides the possibility of generating returns over a period of time.

When an asset is bought or a given amount of money is invested in the bank, there is anticipation that some return will be received from the investment in the future. Investment is a term frequently used in the fields of economics, business management and finance. It can mean savings alone, or savings made through delayed consumption. Investment can be divided into different types according to various theories and principles. While dealing with the various options of investment, the defining terms of investment need to be kept in mind.

Investment banking firms provide their clients with the opportunity to generate funds through different processes. At the same time, they also provide professional services to the investors for identifying different investment opportunities and to invest in the same. The investment banking firms provide various financial services to a wide range of clients. There are both institutional as well as individual clients of these firms. At the same time, these firms also offer a number of services to different national Governments.

- ***Services provided by Investment Banking Firms***

The clients of the investment banking firms are provided with advisory services. The firms also offer a range of capital raising opportunities to the clients. They help the clients to place their equities in such a manner that they can produce highest yields. At the same time, the firms are also involved in the syndication of primary market on behalf of their clients. The investment banking firms also play a major role in arranging debt securities for their clients. The corporate clients of the companies are offered with several other services as well. The mergers and acquisitions are a very important part of the business expansion plans.

The investment banking firms play an important role in creating customized strategies for all these activities. The investment banking services are also available for the activities like divestitures, restructurings, buyouts and others. All these activities need huge amount of money and the investment banking firms are responsible for arranging these funds. At the same time, there are individual clients of investment banking firms. These clients are helped in a number of ways. The firms help the clients to identify the growth prospect of different investment options and to invest in the best one.

4.3 Check Your Progress

1-Explain in brief the similarity between financial companies and banks?

2-Who regulate the pension plan?

3. Explain the distinctive feature of insurance as a transfer device?

Dear Students! Good for you! At this time you completed this part of the course. This is a great success and a sweet fruit of your valuable effort. To finalize the session, read the short summary

below and immediately go to the checklist in order to now your status. In addition, do the self assessment questions as fast as possible and check your result using the answer key provided. I wish you all the best! Meet you in the next module!

4.6. SUMMARY

Financial institutions include banks, credit unions, asset management firms, building societies, and stock brokerages, among others. The functions of financial institutions, such as stock exchanges, commodity markets, futures, currency, and options exchanges are very important for the economy. These institutions are involved in creating and providing ownership for financial claims. These institutions are also responsible for maintaining liquidity in the market and managing price change risks.

A depository financial institution is one that specializes in depository lending, and the services offered by these institutions are a bit different from that of other financial service providers. The depository financial institutions are also known as deposit-taking financial organizations. The primary functions of these institutions are to accept deposits and to use the money collected for lending purposes.

In aggregate, commercial banks are the most dominant depository institution. A Commercial bank is an institution which accepts deposits, makes business loans, and offers related services. They serve surplus units by offering a wide variety of deposit accounts, and they transfer deposited funds to deficit units by providing direct loans or purchasing debt securities.

Savings institutions, which are sometimes referred to as thrift institutions are another type of depository institution. Savings institutions include savings and loan associations (S&Ls) and savings banks. Like commercial banks, S&Ls offer deposit accounts to surplus units and then channel these deposits to deposits to deficit units.

On the other hand a credit union is a cooperative financial institution that is privately owned and controlled by its members. Credit unions differ from banks and other financial institutions in that the members who have accounts in the credit union are the owners of the credit union and they

elect their board of directors in a democratic one person-one vote system regardless of the amount of money invested in the credit union.

As one part of Investment Institutions Mutual funds get money from small savers (individuals), who buy shares in the fund; they in turn invest in variety of stocks, bonds, etc.; allow the individuals to "pool" their savings, diversify (avoid risk). Mutual funds sell shares to investors, and invest the proceeds in a wide choice of assets. The other non depositary institution Pension Funds, protect individuals and families against loss of income in their retirement years by allowing workers to set aside and invest a portion of their current income.

On the other direction insurance companies issue insurance policies in exchange for premiums that protect individuals from losses or damages. Insurance companies protect individuals against risk. Life insurance companies accept regular payments from individuals in exchange for contracted payments in the event of the insured's' death. They are financial service firms selling contracts to customers that promise to reduce the financial loss to an individual or family associated with death, disability, or old age.

Self-Assessment Questions 4

Part I: Multiple Choices

Direction: Choose the best answer from the given alternatives. (10 marks)

1. Which one of the following services are not provided by banks?

A. Issuance of promissory notes,

B. Offering documents related to underwriting commitments for securities

C. Safe custody of important documents and other valuable items in safe deposit vaults or safe deposit boxes

D. Selling and brokerage services related to unit trust and insurance products

E. None of the forgoing.

2. Which one of the following is different from the others?

A. Pre-Shipment Export Credit,
B. Revolving Export Credit Facility,
C. Overdraft
D. Advance On Export Bills,
E. None of the above.

3. _____ is a non-interest bearing deposit account operated by a saving like passbook and vouchers.

A. Fixed (time) Deposit
B. Special Demand Deposit Account (SDDA),
C. Saving Account,
D. Current Account,
E. None of the above.

4. Which one of the following is not a part of financial institutions?

A. Stock brokerage firms,
B. Asset management firms,
C. Building Societies,
D. Retailers,
E. None of the above.

5. When a depository institution offers a loan, it is acting as_____.

A. a creditor,
B. if it had purchased a debt security,
C. if it has invested in treasury bills,
D. All of the above,
E. None of the forgoing.

Part II: Matching

<u>Direction</u>: Match statements under 'Column One' with the correct terms under 'Column Two'

	Part One	Part Two
1	Acting as a go-between for two parties.	A Branch Banking
2	A loan granted to customers to be repaid with interest within a specific period of time.	B Short-term Loan
3	An arrangement whereby a bank maintains deposit balance with other banks at a distant place for a variety of services and assistance.	C Home office
4	Checking account.	D Unit Banking
5	Financial intermediaries pooling deposits of many individuals and investing those in short-term, high quality, money market instruments.	E Insurance Companies
6	A single bank that offers a full-fledged services in two or more offices across the country, including offices abroad.	F Intermediation
7	An organization that offers financial services to the very poor.	G Demand deposit
8	Indirect loans to consumers by purchasing installment paper from dealers selling automobiles and other consumer durables.	H Money Market Funds
9	A banking business operating a single banking office.	I Credit Unions
10	House hold oriented intermediaries, offering deposit and credit services to individuals and families.	J A term loan

K Commercial Finance Companies

L Correspondent Banking

M Sales Finance Companies

N A micro finance institution (MFI)

O None

Part III: True or False

Direction: Say true or false for the following statements.

1. Financial institutions are necessarily regulated by the financial laws of government authority.
2. The major difference between banks and the credit unions is that the bank is owned by the members having accounts in it.
3. Insurance companies provide loans for a number of purposes and create investment products.
4. Un considering the financial structure of the particular country, the functionality of credit unions can be the same in different countries.
5. Micro-finance activities are more diverse in rural areas and include shopkeepers, service providers, artisans, street vendors, etc.

CHAPTER 5: THE REGULATION OF FINANCIAL MARKETS AND INSTITUTIONS

5.0 Objectives

At the end of this unit, you will be able to:

√ Explain why financial institutions are regulated;

√ Elucidate the rules and regulations of financial institutions; and

√ Discern the nature application of financial system policies.

5.1The Nature of Financial System Regulation

Dear learner, now we have entered in to a new chapter which will discuss on financial institutions regulation, so do you think a financial system regulation is necessary?

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A good financial system with a well-functioning competitive market as well as a well-supporting financial institution is an essential ingredient for sustainable economic growth. Developing sound Financial Markets requires the establishment of public confidence in the institutions that constitute the Finance Sector.

Confidence can only be maintained if these institutions deliver services as promised. Thus one of the duties of Governmental Authorities is to preserve the long term stability of the financial system and reliability of its components. Governments could do this using different procedures and regulations. Regulation of financial markets rests on the tenet that it serves the interest of the public by protecting investors and guarding against systemic risk. With regard to investor protection, regulations maintain that their oversight is justified on the grounds that investors are uninformed and unskilled.

The initial focus, and still the central element, of regulatory system is to solve the problem of the uninformed investor through company disclosure and transparency of trading markets. Most people agree that disclosure provides the information needed to make rational decisions. But regulation today goes far beyond disclosure requirements, because a growing number of stakeholders are presumed to be unskilled and incapable of making informed decisions.

The other basis for financial regulation is concern about systemic risk. Systemic risk arises if the failure of one financial institution causes a run on other institutions and precipitates system-wide failure. Regulation is said to be required because individual institutions do not adequately take account of the external costs they impose on the financial system when they fail. But almost every aspect of financial markets, if not daily living itself, involves systemic risk. One of the most complex issues facing governments is identifying the appropriate level and form of intervention.

Regulatory efficiency is a significant factor in the overall performance of the economy. Inefficiency ultimately imposes costs on the community through higher taxes and charges, poor service, uncompetitive pricing or slower economic growth. Clearly there must be limits on the applicability of this rational for regulation.

The financial system is regulated to increase the information available to investors, to ensure the soundness of the financial system and improve control of monetary policy.

One of the other main reasons for having strong financial regulation is increasing information available to investors. For example because of asymmetric information in financial markets, that means investors may be subject to adverse selection and moral hazard problems that may hinder the efficient operation of financial markets. Risky firms or outright crooks may be the most eager to sell securities to unwary investors, and the resulting adverse selection problem may keep investors out of financial markets.

Furthermore, once an investor has bought a security, thereby lending money to a firm, the borrower may have incentives to engage in risky activities or to commit outright fraud. The

presence of this moral hazard problem may also keep investors away from financial markets. Government regulation can reduce adverse selection and moral hazard problems in financial markets and increase their efficiency by increasing the amount of information available to investors.

In similar ways, ensuring the soundness of financial system is the other reason for the necessity of the rules and procedures. Uncertain and confusing information can also lead to widespread collapse of financial intermediaries, referred to as a financial panic. Because providers of funds to financial intermediaries may not be able to assess whether the institutions holding their funds are sound, if they have doubts about the overall health of financial intermediaries, they may want to pull their funds out of both sound and unsound institutions.

The possible outcome is a financial panic that produces large losses for the public and causes serious damage to the economy. To protect the public and the economy from financial panics, the governments are implementing a number of regulations. These regulations are taking the form of Restrictions on Entry; Disclosure; Restrictions on Assets and Activities; Deposit Insurance; Limits on Competition; and Restrictions on Interest Rates.

Dear learner, can you list some of the basic functions of financial system?

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i. Restrictions on Entry

Governments endorse very tight regulations governing who is allowed to set up a financial intermediary. Individuals or groups that want to establish a financial intermediary, such as a bank or an insurance company must obtain a charter from the state or the Federal Government.

ii. Disclosure

There are stringent reporting requirements for financial intermediaries. Their bookkeeping must follow certain strict principles, their books are subject to periodic inspection, and they must make certain information available to the public.

iii. Restrictions on Assets and Activities

There are restrictions on what financial intermediaries are allowed to do and what assets they can hold. Before you put your funds into a bank or some other such institution, you would want to know that your funds are safe and that the bank or other financial intermediary will be able to meet its obligations to you. One way of doing this is to restrict the financial intermediary from engaging in certain risky activities.

For example some counties legislation separates commercial banking from the securities industry so that banks could not engage in risky ventures associated with this industry.

Another way is to restrict financial intermediaries from holding certain risky assets, or at least from holding a greater quantity of these risky assets than is prudent. For example, commercial banks and other depository institutions are not allowed to hold common stock because stock prices experience substantial fluctuations.

iv. Deposit Insurance

The government can insure people's deposits so that they do not suffer any financial loss if the financial intermediary that holds these deposits should fail. All commercial and mutual savings banks, with a few minor exceptions, are required to enter deposit insurance, which is used to pay off depositors in the case of a bank's failure.

5.1 Check Your Progress

1. What is the initial focus of regulatory system?
2. Regulatory efficiency is a significant factor in the overall performance of the economy. What is the impact of inefficiency in regulatory body, on society?
3. There are restrictions on what financial intermediaries are allowed to do (or not to do) and what assets they can hold (or not to hold). Give some example.

5.2 The Principles of Regulation

Dear learner, what do you think of the principles of financial regulation?

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Regulation requires that a careful balance be struck between effectiveness and efficiency. It has great potential to impose costs and should be designed to meet its purposes while minimizing direct costs of regulation and the broader costs arising from rules which restrict economic activity. The main principle of the regulation of the financial markets and institutions includes: Competitive Neutrality; Cost Effectiveness; Accountability; Flexibility; and Transparency

Competitive Neutrality

The regulatory burden applying to a particular financial commitment or promise should apply equally to all who make such commitments, as per the competitive neutrality principle. It requires further that there would be: Minimal barriers to entry and exit from markets and products; No undue restrictions on institutions or the products they offer; and Markets open to the widest possible range of participants.

Cost Effectiveness

Regulation can be made totally effective by simply prohibiting all actions potentially incompatible with the regulatory objective. But, by inhibiting productive activities along with the anti-social, such an approach is likely to be highly inefficient. Cost effectiveness is one of the most difficult issues for regulatory cultures to come to terms with. Any form of regulation involves a natural tension between effectiveness and efficiency. Yet the underlying legislative framework must be effective, by fostering compliance through enforcement in cases where participants do not abide by the rules. In general, a cost-effective regulatory system may require:

- ✓ An allocation of functions among regulatory bodies which minimizes overlaps, duplication and conflicts;
- ✓ An explicit mandate for regulatory bodies to balance efficiency and effectiveness;
- ✓ The allocation of regulatory costs to those enjoying the benefits; and
- ✓ A presumption in favor of minimal regulation unless a higher level of intervention is justified.

iii.Accountability: The regulatory structure must be accountable to its stakeholders and subject to regular reviews of its efficiency and effectiveness. In addition, regulatory agencies should operate independently of sectional interests and with appropriately skilled staff.

iv. Flexibility: The regulatory framework must have the flexibility to cope with changing institutional and product structures without losing its effectiveness.

Transparency:

Transparency of regulation requires that all guarantees be made explicit and that all purchasers and providers of financial products be fully aware of their rights and responsibilities. It should be a top priority of an effective financial regulatory structure that financial promises (both public and private) be understood. If there is a general perception that a particular group of financial institutions cannot fail because they have the authorization of Government, there is a great danger that perception will become a reality.

5.3 Arguments for and against Financial System Regulations

Dear learner,

The financial system is among the most heavily regulated sectors of most economies. The Government regulates financial markets for different reasons. But, there are different views as to the need and extent of Government intervention in financial markets. Some argue that free and competitive markets can produce an efficient allocation of resources and provide a strong foundation for economic growth and development. Others emphasize that Governments could play in maintaining a healthy economic and social environment in which enterprises and their customers can interact with confidence.

Since deferent scholars have contradictory stands for or against the regulations it is better to examine about some reasons that have led to the present regulatory environment. Some of the views for or against financial market regulations include: Regulation for Financial Safety; Systemic Stability; Information Asymmetry; Regulatory Assurance; and Regulation for Social Purposes.

i. Regulation for Financial Safety

One of the vital economic functions of the financial institutions is to manage, allocate and price risk. However, there are some areas of the financial activities where government intervention is aimed at eliminating or reducing risk.

In essence, the task is to decide which financial promises have characteristics that warrant much higher levels of safety than would otherwise be provided by markets (even when they are subject to effective conduct, disclosure and competition regulation). As a general principle, financial safety regulation will be required where promises are judged to be very difficult to honor and assess, and produce highly adverse consequences if breached. Promises which rank highly on these characteristics are referred to as having a high 'intensity'.

The higher the intensity of a promise, the stronger the case for regulation to reduce the likelihood of breach.

On the other hand, many regulations in the financial institutions' sector spring from the ability of some financial institutions to create money in the form of credit cards, checkable deposits, and other accounts that can be used to make payments for purchase of goods and services. Such creation of money is closely associated with inflation which should be managed by the government. Financial regulation arises from the risks attaching to financial promises. While in some other industries safety regulation aims to eliminate risk almost entirely (for example, to eliminate health risks in food preparation), this is not an appropriate aim for most areas of the financial activities.

ii. Systemic Stability

The more sophisticated the economy, the greater is its dependence on financial promises and the greater its vulnerability to failure of the financial system.

The first case for regulation to prevent systemic instability arises because of certain financial promises have an inherent capacity to transmit instability to the real economy, inducing undesired effects on output, employment and price inflation.

When financial distress in one market or institution is communicated to others and, eventually, engulfs the entire system, there will be the most potent source of systemic risk is financial contagion.

> The position of banks as the main providers of payments services adds to the risk that bank failure might disrupt the integrity of the payments system and precipitate a wider economic crisis.

iii. Information Asymmetry

Information Asymmetry is a situation where further disclosure, no matter how high quality or comprehensive, cannot overcome market failure. The second case for regulation relates to the need to address information asymmetry. In a market economy, consumers are assumed, for the most part, to be the best judges of their own interests. In such cases, disclosure requirements play an important role in assisting consumers to make informed judgments. However, disclosure is not always sufficient.

For many financial products, consumers lack (and cannot efficiently obtain) the knowledge, experience or judgment required to make informed decisions. In these cases, it may be desirable to substitute the opinion of a third party for that of consumers themselves. In effect, the third party is expected to behave paternalistically, looking out for the best interests of consumers when they are considered incapable of doing so alone. To some extent, such third parties can be supplied by markets (such as the role played by self regulatory associations). However, for many years the practice in all countries has been for Government prudential regulators to take on much of this role.

iv. Regulatory Assurance

If regulation is pursued to the point of ensuring that promises are kept under all circumstances, the burden of honor is effectively shifted from the promisor to the regulator. All promissory would become equally risky (or risk free) in the eyes of the investing public. Regulation at this intensity removes the natural spectrum of risk that is fundamental to financial markets. If it were extended

widely, the community would be collectively underwriting all financial risks through the tax system, and markets would cease to work efficiently.

A concern about the safety of the public's funds, especially the savings owned by millions of individuals and families, however, does not mean that all financial services should be subject to financial safety regulation. Thus, regulation cannot and should not ensure that all financial promises are kept. The Government should not provide an absolute guarantee in any area of the financial system (just as it does not do so in other areas).

How intensively, then, should financial safety regulation be applied?

Theoretically, however, the intensity of financial safety regulation should be proportional to the intensity of financial promises. A large amount of intense financial promises are those which provide payments services. Such promises are intrinsically difficult to honor. Those who use them rarely have the time, motivation or resources to assess the risks, and any breach would have potentially highly adverse consequences for the efficient conduct of commerce in the whole economy.

The most intense safety regulation should therefore apply to the provision of means of payment, to the point of securing their safety at the highest possible level, short of an outright Government guarantee. Beyond this, the extent of regulatory assurance is a matter for judgment.

Where systemic risk and information asymmetry are greatest, regulation should at least strive to minimize the risk of promises being dishonored.

How much regulatory assurance should it provide in the various areas of the financial system?

At a minimum, this requires that the regulator have unambiguous powers to intervene in the operations of institutions making such intense promises. ***Regulation should seek to ensure that, while risk remains, those making promises ensure that risks are appropriately managed in accordance with the reasonable expectations of their promises.*** If regulation stops short of providing a guarantee against failure, it must provide speedy and efficient mechanisms for resolving financial distress when it arises, so as to minimize the danger of loss or contagion.

v. Regulation for Social Purposes

Obliging financial institutions to subsidies some activities compromises their efficiency and is unlikely to prove sustainable in a competitive market. A further case for regulation is sometimes made on the grounds that financial institutions have 'community service obligations' to provide subsidies to some customer groups.

For example, financial institutions are urged to deliver certain services free of charge or at a price below the cost of provision. This is the least persuasive case for intervention. Financial institutions, like other business corporations, are designed to produce wealth, not to redistribute it. This is not to say that their creation of wealth should ignore the claims of social and moral propriety. But it is another thing entirely to require financial institutions to undertake social responsibilities for which they are not designed or well suited.

5.2 Check Your Progress

1. Ensuring the soundness of financial system is one of the reasons for the necessity of the rules and procedures. What is the consequence of uncertain and confusing information up on the investor or the society in general?
2. What are the strict reporting requirements for financial intermediaries?
3. What are the main principles of the regulation of the financial markets and institutions?
4. What is the need for regulation to prevent systemic instability arises?

5.3. Summary

The development of a sound financial industry is partly in the hands of the legislators and supervisors. They have to establish the framework for the healthy development of these industries and to deal with the incidences of market failure and imperfections. This should benefit not only consumers but also the economy as a whole through better protection of the existing and future wealth of the country, the availability of more funds for investment purposes and the strengthening of state finances through tax incomes.

The financial system warrants specialized regulation due to the complexity of financial products, the adverse consequences of breaching financial promises and the need for low-cost means to resolve disputes. All markets, financial and non-financial, face potential problems associated with the conduct of market participants, anti-competitive behavior and incomplete information. These

common forms of market failure have justified at least a minimum level of regulatory intervention in markets on an economy wide basis. There are some markets where this minimum level of economy wide regulation is considered to be inadequate.

In the financial system, specialized regulation is required to ensure that market participants act with integrity and that consumers are protected. If a borrower from bank, having a financial guarantee from an insurance firm, fails to pay the debt as per the agreement, the bank will collect the amount from the insurance company. The longer the period and the higher the number of default customers would endanger the operation of insurance companies and banks as many of the banks have invested on insurance companies.

The regulation which prohibits insurance companies from providing financial guarantee 'therefore, would contribute for the minimization of systemic risk in the country's financial sector. Regulation imposes costs directly for their implementation and indirectly on the wider economy as it restricts some economic activities. This highlights the need to balance prudential and efficiency considerations.

For market efficiency reasons, regulation must also take account of the risk that some financial failures may have onerous/heavy consequences for financial system stability and hence the real economy. In different countries introduction of market economy principles and liberalization fundamentally changed the state involvement in the monitoring of financial operations. The role of the state has evolved towards establishing market conduct rules, and prudential regulations, particularly focusing on solvency and consumer protection measures.

Self-Assessment Questions 5

Part I: Multiple Choices

Direction: Choose the best answer from the given alternatives. (10 marks)

1. Inefficiency of the financial system regulatory body imposes costs on the community through_____.
   A. Lower taxes and charges,
   B. Privileged service,
   C. Competitive pricing or stronger economic growth,
   D. All of the above,
   E. None of the above.
2. In relation to the financial system regulation concerning disclosure, which one of the following statement is not true about intermediaries?
   A. There is no reporting requirements,
   B. Their bookkeeping must follow certain strict principles,
   C. Their books are subject to periodic inspection,
   D. They must make certain information available to the public,
   E. None of the above.
3. Which one of the following statement is\are wrong?
   A. Unbridled competition among financial intermediaries promotes failures that will harm the public,
   B. All commercial and mutual savings banks, with a few minor exceptions, are required to enter deposit insurance,
   C. The government is not expected to insure people's deposits so that they do not suffer any financial loss if the financial intermediary that holds these deposits should fail.
   D. All of the above,
   E. None of the above.
4. As per the competitive neutrality principle,
   A. No undue restrictions on institutions or the products they offer,
   B. There should be maximal barriers to entry and exit from markets and products,
   C. Markets open to the widest possible range of participants,

D. All of the above

E. None of the above.

5. A cost-effective regulatory system may requires all of the following, except,

A. An allocation of functions among regulatory bodies which minimizes overlaps, duplication and conflicts,

B. An explicit mandate for regulatory bodies to balance efficiency and effectiveness,

C. Presumption in favor of minimal regulation unless a lower level of intervention is justified,

D. All of the above,

E. None of the above.

Part II: MATCHING

Direction: Match statements under 'Column One' with the correct terms under 'Column Two'

Column One		Column Two	
1	The regulatory structure must be responsible to its stakeholders and subject to regular reviews of its efficiency and effectiveness.	**A**	Systemic Stability
2	A situation where further disclosure, no matter how high quality or comprehensive, cannot overcome market failure.	**B**	Transparency
3	The regulatory framework must have the flexibility to cope with changing institutional and product structures without losing its effectiveness.	**C**	Regulation for Social Purposes
4	Allowed to hold common stock, but their holdings cannot exceed a certain fraction of their total assets.	**D**	Restrictions on Entry
5	Regulation can be made totally effective by simply prohibiting all actions potentially incompatible with the regulatory objective.	**E**	Regulatory Assurance
6	Regulated to increase the information available to investors, to ensure the soundness of the financial system and improve control of monetary policy.	**F**	The financial system

7	All guarantees are made explicit and that all purchasers and providers of financial products be fully aware of their rights and responsibilities.	**G**	Flexibility
8	Financial institutions have community service obligations to provide subsidies to some customer groups.	**H**	Competitive Neutrality
9	The regulatory burden applying to a particular financial commitment or promise should apply equally to all who make such commitments.	**I**	Developing sound Financial Markets
10	Individuals or groups that want to establish a financial intermediary, such as a bank or an insurance company, must obtain a charter from the state or the federal government.	**J**	Information Asymmetry
		K	Accountability
		L	Insurance companies
		M	Cost Effectiveness
		N	None of the forgoing

Part III: True or False

Direction: Say true or false for the following statements.

1-With regard to investor protection, regulations maintain that their oversight is justified on the grounds that investors are informed and skilled.

2-Regulation is said to be required because individual institutions do not adequately take account of the external costs they impose on the financial system when they fail.

3-Risky firms or outright crooks may be the most eager to sell securities to unwary investors.

4-Regulatory agencies should operate dependently of sectional interests and with appropriately skilled staff.

5-The more sophisticated the economy, the greater it's dependence on financial promises and the lower its vulnerability to failure of the financial system.

CHAPTER 6: FINANCIAL INSTITUTIONS AND MARKETS IN ETHIOPIA

6.0 Objectives:

At the end of this unit, you should be able to:

- √ Differentiate activities and services of commercial banks in Ethiopia;
- √ Portray the characteristics of insurance services in Ethiopia;
- √ Discuss the development of insurance industry in Ethiopia;
- √ Describe the nature of micro finance institutions in Ethiopia;
- √ Distinguish the role of National Bank of Ethiopia.

6.1Ethiopian Financial System:

6.1.1 Evolution of Banking in Ethiopia

Dear learner: Have you ever noticed when banks are started in Ethiopia, How they functions, how many were there, who owns banks etc?

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The history of banking in Ethiopia dates back to the turn of 20th century when the Bank of Abyssinia was established in 1905 with objective of promoting banking habit. The Bank of Ethiopia was established later in 1931 retaining the offices and personnel of the old bank. During the period of Italian occupation, the banking business was held Italian banks. Between 1943 and 1963 all aspects of banking activities central, commercial, savings and mortgage, was dominated by the State Bank of Ethiopia.

A ground-breaking phase in the history of Ethiopian banking was started with the introduction of monetary and banking proclamation of 1963.

With the coming into effect of this proclamation, the State Bank of Ethiopia was split into two separate bodies: The National Bank of Ethiopia and the Commercial Bank of Ethiopia. The former

assumed central banking functions while the latter took up commercial banking business of the old bank.

The Housing and Savings Bank was established in 1975 by proclamation No.60/1975 decreeing the transfer of all assets and liabilities of the former Savings and Mortgage Corporation of Ethiopia S.C. and the Imperial Savings and Home Ownership Public Association (ISHOPA). The bank was established with the objective of providing loans for residential and commercial construction industries.

As part of the recently launched economic reform, different financial liberalization measures and restructuring of financial institutions have been undertaken.

All the measures have the aim of promoting a competitive environment and efficient banking services to the public. The Commercial Bank of Ethiopia was re-established in 1994 by proclamation No. 202 taking over the rights and obligations of the Commercial Bank of Ethiopia which was established under proclamation No. 184/1980. The Construction and Business Bank has also been established under proclamation No. 203/1994 by taking over the rights and obligations of the Housing and Savings Bank which was established under proclamation No. 60/1975.

The bank's objectives include providing loans for construction, repair, modification and acquisition of dwelling houses and buildings, for construction sector activities and for the development of hotels and tourism, accepting savings, demand and time deposits, administering funds entrusted to it by the government or other institutions and carrying out all other activities as are customarily done by banks.

The Development Bank of Ethiopia has also been established by Regulation No. 200/1994. The bank took over the rights and obligations of the Agricultural and Industrial Development Bank which was established under proclamation No. 158/1979. The bank's objectives include mobilizing funds from sources within and outside the country and providing medium and long term investment credits, holding savings, demand and time deposits, acting as a trustee and other activities usually performed by development banks.

The banking industry in Ethiopia has experienced change in its ownership, structure, level of competition, regulatory environment and greater supervision since 1994.

The first, Monetary and Banking Proclamation No. 83/1994, defines the powers and responsibilities of the National Bank of Ethiopia which is the Central Bank of the country. The second, a proclamation to provide for the Licensing and Supervision of Banking Business No. 84/1994, which sets out the conditions under which commercial banks can be licensed and the supervisory requirements they should observe in the course of their operation.

With the coming into effect of the Licensing and Supervising Banking Business Proclamation different private banks have also emerged and joined the market since 1994. For instance, *Awash International Bank, Dashen Bank, Bank Of Abyssinia, Wegagen Bank, United Bank, Nib International Bank, Cooperative Bank of Oromia, Lion International Bank, Zemen Bank, Oromia International Bank, Buna International Bank and Berhan International Bank, Abay Bank, Addis International Bank, and Enat Bank* are among the private banks established in the country. By now different banks are emerging from time to time basing the favorable conditions and welcoming policies facilitated in the country.

6.1.2 The Origin of NBE at a glance

Dear leaner, what do you think is the role of NBE?

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_____

February 15, 1906 marked the beginning of banking in Ethiopia when the first Bank of Abyssinia was inaugurated by Emperor Menelik II. It was a private bank whose shares were sold in Addis Ababa, New York, Paris, London, and Vienna. One of the first projects financed by the bank was the Franco-Ethiopian Railway which reached Addis Ababa in 1917. In 1931, Emperor Haile Selassie introduced reforms into the banking system and the Bank of Abyssinia became the Bank of Ethiopia, a fully government-owned bank providing central and commercial banking services.

The Italian invasion in 1935 brought the demise of one of the earliest initiatives in African banking. During the Italian occupation, Italian banks were active in Ethiopia. On April 15, 1943, the State Bank of Ethiopia became the central bank and was active until 1963.

The National Bank of Ethiopia was established in 1963 by Proclamation No.206 of 1963 and began operation in January 1964.

Prior to this proclamation, the Bank carried out dual activities, i.e. commercial banking and central banking. The proclamation raised the Bank's capital to 10 million Ethiopian birr and granted broad administrative autonomy and juridical personality. Following the proclamation, the National Bank of Ethiopia was entrusted with the following responsibilities:

- √ To regulate the supply, availability and cost of money and credit;
- √ To manage and administer the country's international reserves;
- √ To license and supervise banks and hold commercial banks reserves and lend money to them;
- √ To supervise loans of commercial banks and regulate interest rates;
- √ To issue paper money and coins;
- √ To act as an agent of the Government; and
- √ To fix and control the foreign exchange rates.

However, monetary and banking proclamation No. 99 of 1976 came into force on September 1976 to shape the Bank's role according to the socialist economic Principle that the country adopted. Hence the Bank was allowed to participate actively in national planning, specifically financial planning, in cooperation with the concerned state organs. The Bank's supervisory area was also increased to include other financial institutions such as insurance institutions, credit cooperatives and investment-oriented banks. Moreover the proclamation introduced the new 'Ethiopian birr' in place of the former one that ceased to be legal tender.

The proclamation revised the Bank's relationship with Government. It initially raised the legal limits of outstanding Government domestic borrowing to 25% of the actual ordinary revenue of the

Government during the preceding three budget years as against the proclamation 206/1963, which set it to be 15%. This proclamation was in force till the new proclamation issued in 1994 to reorganize the Bank according to the market-based economic policy so that it could foster monetary stability, a sound financial system and such other credit and exchange conditions as are conductive to the balanced growth of the economy of the country.

6.1 Check Your Progress

1. The first Monetary and Banking Proclamation No. 83/1994 defines the powers and responsibilities of the National Bank of Ethiopia which is the Central Bank of the country. How about the second proclamation?
2. What were the responsibilities of the National Bank of Ethiopia when it was established 1963?

6.1.3 Evolution of Insurance in Ethiopia

Dear leaner, when do you think is the first insurance company established in Ethiopia?

_____

_____

The term insurance can have different definitions. However, the main purpose of insurance is helping individuals in case of financial problems resulting from misfortune by pooling such risks from many people. The commercial code of Ethiopia defines insurance from the legal point of view as *"contract whereby a person called the insurer undertakes against payment of one or more premiums to pay to a person, called the beneficiary, a sum of money where a specified risk materializes."*

From the very definitions of the insurance, there are two parties: the insured and the insurer. The insured transfers his risk to the insurer and to this effect, he will have to pay the price which in insurance terminology is called premiums; whereas the insurer will make financial compensation to the instead and the insurer assumes or retains risk and provides protection against financial loss according to the insured in variety of situations as specified in their binding contract; accordingly, insurances security against financial hardship.

It is believed that insurance service was started in ancient China and Greek. The code Hammurabi, a collection of Babylonian laws of the 1700's B.C, included a form of credit insurance. Ancient Greek and Roman organizations provide money for burial of their members, old -age pension and disability insurance. During the middle ages, associations formed by aircraft workers offered the same type of insurance as well theft insurance to their members.

Modern insurance service was started in the 13th Century in a main town of Lombardi, a Region called Florence, in Northern Italy.

Then after, it was expanded to England, France and other European countries through traders and gradually to the rest of the world.

In Ethiopia insurance practice was started through religious organizations. The organizations around the Orthodox Church used to practice and participate in Senbetes, Mahber, Edir and Ekub. These were insurance- like practices and exist along side the real insurance practices. These organizations had contributed a lot to the development of insurance practice in Ethiopia. Contemporary type of insurance practice developed in Ethiopia during the Imperial time.

During this time, particularly in 1905 insurance practice began in Ethiopian when Bank of Abyssinia, a branch of the Bank of Egypt, sold the first Fire and Marine insurance polices as an agent to a foreign insurance company. In 1922, a company named institu to per Lavoro Nazionale per Employer's Liability insurance through its local agent. In 1923 an Austrian National Insurance named Weinzinger issued policies as agent of "LABALIOIS" Fire Insurance Company in 1929 paid the first fire loss of a commercial building in Ethiopia.

However, during the Italian occupation of 1932 all insurance activities were taken over by the Italian insurance companies. In 1941 immediately after the war of the occupation period, foreign insurance companies like phoenix, Caledonia, Royal, and south British of London sold different policies through their respective local agents. In 1947, South British Company of Great Britain issued the first motor policy and until 1950, 99% of the policyholders were foreigners.

The first local insurance company, the imperial insurance S.C. was established in 1951.

Though foreign initiated, the company has opened a new chapter in history of the Ethiopian insurance industry. The only legal provisions available at the time were the1960 commercial and Maritime Codes. In 1970, the insurance proclamation no. 281/1970 came into effect and as a result of this proclamation 16 insurance companies were licensed, namely:

1. Imperial Insurance Company;
2. African Solidarity insurance Company;
3. Lion insurance Company;
4. Blue Nile Insurance Company;
5. International Insurance Company;
6. Union Insurance Company;
7. General Insurance Company;
8. National Insurance Company;
9. Afro-Continental Insurance Company;
10. Pan Africa Insurance Company;
11. Rasai Ethiopian Insurance Company;
12. Ethiopian Life Insurance Company;
13. Ethio- American Life Insurance Company;
14. Queen of Sheba;
15. Ras Insurance Company; and
16. Star Insurance Company.

During the Derg regime, the activities of the insurance companies were threatened. It was a socialist orientation period where the restructuring of the financial system was in process. In 1975 all the 13 insurance companies and agencies working with them were nationalized as per proclamation no. 68/1975 issued in February6 1975. At first, the three nationalized companies were allowed to continue as a separate entity for one year. Thereafter, all of them were amalgamated into one body and the Ethiopian Insurance Corporation was established at a capital of 1 million. The Corporation was then organized into 5 main branches and one life branch and gained monopoly power. Rate fixing, preparation of policies, and manuals and procedures works

were performed. Reinsurance arrangements improved and competition confined to be among branches only.

Immediately after the present government (EPRDF) came into power, the most important functions performed were to restructure the country's economy from state-controlled to a free market economy, build-up a market based economy, and allow the private sector to be involved in insurance and banking businesses.

Accordingly, the Banking and insurance proclamation no. 86/1994 were issued to this effect declaring that the minimum capital requirement for General insurance to be Birr 3 million and for life insurance Birr 4 million. Gradually many private insurance companies were established. The following are the private insurance companies established in Ethiopia after the introduction of free market economy but up to the end of the year 2005 E.C.:

1. National Insurance Company of Ethiopia (NICE);
2. Awash Insurance S.C (AIC);
3. Africa Insurance S.C (AIC);
4. Nile Insurances S.C (NIC);
5. Nyala Insurances S.C (NISCO);
6. United Insurance S.C. (UNITED);
7. Global Insurance S.C. (GIC);
8. Lion Insurance S.C. (Late merged with United);
9. Nib Insurance S.C. (NIB);
10. Universal Insurance .S.C. (Later Liquidated); and
11. Nice Insurance Company of Ethiopia S.C.
12. Birhan International Insurance
13. Abay Insurance S.C.
14. Lucy Insurance S.C.
15. Ethio-Life Insurance S.C.

6.1.4 The role of National Bank of Ethiopia

Dear learner, Do you know why the NBE is established?

One of the most important financial institutions in any modern economy is the National Banks (Central Banks). Basically, a National Bank is an agency of government-which is not concerned with maximizing its profit, has an important public policy functions in monitoring the operations of the financial system and controlling the growth of its money supply. National banks ordinarily do not deal directly with public; rather they are "bankers' banks," communicating with commercial banks and securities dealers in carrying out their essential policy making functions.

Powers and Duties of the National Bank

What are the authorities and responsibilities of National Bank Ethiopia?

For the fulfillment of its purposes, currently, the National Bank have the powers and duties to:

1. Coin, print or cause to be coined, printed and circulated the legal tender currency;
2. Dispose or cause to be disposed coins and notes issued legally;
3. Issue its own debt and payment instruments;
4. Regulate and determine the supply and availability of money and credit as well as the applicable interest rates and other charges;
5. Formulate and implement exchange rate policy;
6. Manage and administer the international reserves of Ethiopia;
7. License and supervise banks, insurers and other financial institutions;
8. Create favorable conditions for the expansion of banking, insurance and other financial services;
9. Set limits on gold and silver bullion and foreign exchange assets of banks and authorized dealers can hold;
10. Set limits on the net foreign exchange position and on the terms and the amount of external indebtedness of banks and other financial institutions;
11. Make short term and long term refinancing facilities available to banks and other financial institutions as might be necessary;
12. Accept deposits of any kind from foreign sources;

13. Collect data from any person and prepare periodic economic studies, on the balance of payments, money supply, price forecasts and other relevant statistical indicators for analysis and for the formulation and determination of monetary, saving and exchange policies as are useful to Ethiopian economy;
14. Act as banker, fiscal agent and financial advisor to the Government;
15. Take such steps to establish, modernize, conduct, monitor, regulate and supervise payment, clearing and settlement systems;
16. Act in compliance with international monetary and banking agreements of Ethiopia and represent Ethiopia in the International Monetary Fund and other international financial organizations formed by central banks;
17. Coin special commemorative coins;
18. Establish and manage deposit insurance fund;
19. Exercise such other powers and functions to execute its purposes as central banks customarily perform.

Accordingly, the main responsibility of the National Bank of Ethiopia is to maintain price stability including exchange rate stability, ensuring fair competitiveness and soundness of the financial system and enhancing the economic progress of the country in pursuit of its mission. Since early 1990s, which marks a period of transition from a command economy to a market-based economy, the NBE has been at the forefront in formulating and implementing policies that enhance macroeconomic and financial stability. The coordination of fiscal and monetary policies, over the past years, has resulted in the achievement of remarkable economic progress with price stability.

The NBE directed its efforts to enact a series of regulations that would allow the establishment of financial institutions and strengthen the regulatory and supervisory capacity of the Bank.

The main functions of the National Bank of Ethiopia are:

1. Control of the money

Money is anything that serves as a medium of exchange in the purchase of goods and services. Money has another important function, however serving as a store of value, for money is a financial asset that may be used to store purchasing power until it is needed by the owner. If money is defined exclusively as medium of exchange, then the sum of all currency and coin held by the public plus the value of all publicly held checking accounts and other deposits against which drafts may be made would constitute the money supply.

If money is defined as a store of value, on the other hand, then time and savings accounts at the commercial banks and other non-bank financial intermediaries, such as credit unions would also be considered important components of the money supply.

The National Banks has the power to regulate money supply and value. It is the source of currency and coin (pocket money) used by the public, but also the principal Government agency is responsible for stabilizing the value of currency and protecting its integrity in the international financial markets.

Why is control of money supply important?

Dear learner, before we attempt to address the above question , can you list some of the reason for controlling the supply of money?

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_____

First, changes in money supply are closely linked to changes in economic activity. To this end, if the National Banks carefully controls the rate of growth of money, it can influence the growth rate of the economy as whole.

Second, in the absence of effective controls, money in the form of paper notes or bank deposits could expand virtually without a limit. The marginal cost creating additional units of money is close to zero. Therefore, the banking system, the Government, or both are capable of increasing the

money well beyond the economy's capacity to produce and services. Because this action would bring on severe inflation, disrupt the payment mechanism, and eventually bring business activity to a halt, it is not surprising that modern Governments have come to rely so heavily on National Banks as guardians of the quantity and value of their currencies.

2. Stabilizing financial markets (Regulation and supervision)

The financial system transmits savings to those who require funds for investment so that the economy can grow. If the system of money and capital markets is to work efficiently, however the public must have confidence in the financial institutions and be willing to commit savings to them. If the financial markets are uncontrollable (unregulated unsupervised), with extremely volatile fluctuations in interest rates and security prices, or if financial institutions are prone to frequent collapse, public confidence in the financial system might well be lost.

The flow of capital funds will dry up, resulting in a drastic slowing in the rate of economic and a rise in unemployment. All National Banks play a vital role in fostering the mature development of financial markets and ensuring a stable flow of funds through those markets. Pursuing on this objective, the National Banks from time to time, provide funds to major securities dealers when they have difficulty financing their portfolios so that buyers and sellers may easily acquire or sell securities.

When the money supply and interest rates rise or fall more rapid than seems consistent with economic goals, the National Banks again intervenes in the financial markets.

The National Banks may change the rates it charges banks on direct loans or engage in securities trading in attempt to moderate changes occurring in the money and capital markets.

3. Lender of the last resort

Another essential function of National Banks is to serve as a lender of last resort. This means providing liquid funds to those financial institutions squeezed by severe liquidity pressures, especially when alternative sources of funds have dried up.

The reason the National Banks is able and willing to make loans at such time is that it has the power to create reserves.

4. Providing information to the public

Another critical function, which the National Banks has performed particularly in recent years, is the provision of information to the public. The National Banks has research staffs that follow current economic and financial developments and recommend changes in policy. The National Banks makes available on a daily, weekly, and monthly basis an impressive volume of statistical releases, special reports, and studies concerning the financial markets, the nation's money supply, long term and short term interest rates, etc.

5. Maintaining and improving the payments mechanism

Finally national banks have a role to play in maintaining and improving a nation's payments mechanism. This involves clearing checks, providing an adequate supply of currency and coin, wiring funds, selling Government securities and preserving confidence in the value of the fundamental monetary unit. A smoothly functioning and efficient payments mechanism is vital for carrying on business and commerce. If checks cannot get the currency and coin it needs to carry out transactions, business activity will be severely curtailed .The result might well be large scale unemployment and a decline in both capital investment and the rate of economic growth.

6.2 Check Your Progress

1-List the reason for control of money supply in the economy?

2-When do you think Insurance has been established?

6.2 Commercial Banking and Insurance

6.3.1 Commercial Banking in Ethiopia

Dear learner, By now I hope you have understand what commercial banks do and their types. Can you list some of the roles played by the commercial banks in our country?

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A Commercial bank is an institution which accepts deposits, makes business loans, and offers related services. Commercial banks allow a variety of deposit accounts, such as checking, savings, and time deposit.

These institutions are run to make a profit and owned by a group of individuals

While commercial banks offer services to individuals, they are primarily concerned with receiving deposits and lending to businesses.

Banking activity, as a part of the economy of any country, plays a vital role for the development of the economy particularly in the investment sector. Even if, modern banking has began in Ethiopia in 1905 (as expressed above/in the previous sub section), when the bank of Abyssinia was first established in Addis Ababa under a 50-Year franchise agreement with the then British owned National Bank of Egypt.

However, the environment was not smooth for more than half of a century for banking business until the economic reform was made in 1991. Following the economic reform, the number of banks in Ethiopia is increasing from time to time. This is a radical change in Ethiopian banking businesses.

> The expansion of banking business in Ethiopia is currently encouraged by the expansion of private companies and this is a new era in the banking system in this land.

Many of the banks in Ethiopia are reporting profit since their establishments. We are also observing a continuous expansion of branches in different corner of the capital city and regions. It gives the impression that the sector is promising.

6.3.1.1The role of commercial banks in the economy

The role of commercial banks is unique among all the other financial institutions. Commercial banks are the vehicle through which credit and monetary policies are transmitted to the economy. In addition, commercial banks deal in a wide variety of assets and accommodate different types of borrowers.

What are the major activities of banking sectors?

The major activities/role of commercial banks is illustrated below:

i. Deposit mobilization

The source of fund to banks is from deposits that customers made in their saving, current, demand deposit, and time deposits.

ii. Granting Credit/Loans

The uses of funds that are mobilized are to provide or grant loans to investors in return to payment of interest and the principal amount granted periodically. Therefore banks use the funds mobilized for providing loans. The activities of granting loans can be dealt using two aspects i.e. outstanding credits/loans available and disbursement of fresh/new loans.

iii. Collection of loans

Loans of course are not granted for, thus revealing payments/collections periodically to the terms and agreements are critical to the survival and existence of the banks. Performing a healthy loan must prevail for the good image of the banks as well as for a better economic development of the country as a whole. Non-performing loans are unhealthy loans, which are the result of uncollectible disbursed loans.

iv. Interest rate development

Following the liberalization of interest rate by the NBE in January 2, 1995 every bank are mandated to set their own lending and deposit rates given the minimum deposit rate set by the NBE. To this effect, every bank are practicing interest rate development using loan and saving

pricing techniques by setting the prime-lending rate taking into considerations the costs associated to granting loans.

v.Banks deposit at NBE

Following the reserve requirements, commercial banks deposit money at the NBE.

vi. Treasury bills market

Commercial banks do participate in the treasury bills market to invest their idle money for short period of time.

vii. Foreign exchange transaction

Commercial banks usually participate in retail foreign exchange markets. They purchase and sale foreign currencies from exporters and importers and facilitate the import and export market transactions by providing letter of credit facility to customers.

6.3.1.2 Current regulations of Ethiopian Government concerning commercial banks

Banks control the payment system and Government monetary policy is implemented through the banking system. The huge mobilized funds from within and outside the country can be utilized in the economic development through the banking system. Because of this and other special roles that these institutions play in the financial system, they are highly regulated in Ethiopia-as it is true in other countries. The general reasoning behind regulating banks is almost the same as what we will discuss for insurance. Below are some of the basic regulations applicable to banks in Ethiopia:

i. Licensing banks

- License for doing banking business is issued by the National Bank of Ethiopia,
- Foreign national shall not undertake banking business in Ethiopia.

ii. Maintenance of Required Capital and Reserve requirement

As per the revised directive of SBB No. 24/99 the minimum paid-up capital to obtain a banking business license is birr 75,000,000. However, nowadays the minimum capital requirement for establishing a bank has been raised to a minimum of 500 million Ethiopian birr. Every existing

bank shall at all times maintain minimum unimpaired capital of five hundred million birr to commensurate with the volume of their business to withstand adverse effects, which shall be fully paid in cash and deposited in bank in the name and to the account of the bank. According to proclamation 84/1994, and directive 27/99, at the end of each fiscal year, every bank shall maintain a legal reserve of not less than 25% (twenty five percent) of its net profit.

One of the important monetary policy instruments and prudential regulation tools is reserve requirement. In this regard, banks carrying on business in Ethiopia shall maintain with the NBE a reserve account 5% (though now it is increased to 15%) of all birr and foreign currency deposit liabilities held in the form of current, saving and time deposits.

iii. Disclosure requirement (Audit, Information, Inspection and Examination)

Accordingly to Proclamation 84/1994, every bank shall appoint an independent auditor to report to the shareholders of the bank upon the annual balance sheet and profit and loss statement, whether they exhibit a true and fair statement of the Bank's affair and the copy of the report shall be sent to the NBE not later than 90 days after the end of financial year. Each bank shall send to NBE the duly signed Balance Sheet every month within 20 days from the end of each month, balance sheet and profit and loss statement every six month and every year within one month from the closing of each financial year. In addition the NBE may periodically or at any time, without prior notice make or cause an on-site inspection to be made of any bank whether the inspected or examined bank has failed to comply with applicable laws or regulations or with the terms and conditions of the license to carry on banking business in Ethiopia.

iv. Limitation of the activities of Banks

The activities of banks are regulated by the government. Without the prior written approval of the NBE, no person may acquire either directly or indirectly in a bank a voting right exceeding 20% (twenty percent) of the total capital. No bank shall enter into any arrangement or agreement for the sale or disposal by amalgamation or effect restructuring, dispose of the whole or any part of its property whether in or out of Ethiopia and other activities not given by the provision of proclamation no 83/1994. The overall open foreign currency position of each bank at the close of business day shall not exceed 15% (fifteen percent) of its total capital.

The aggregate sum of loans extended or permitted to be outstanding directly or indirectly to one related party and related parties at any one time shall not exceed 15% (fifteen percent) and 35%(thirty five percent) respectively of the total capital of the bank. The aggregate loan or extension of credit by a bank to any one borrower, either a natural person or business organization at no time shall exceed 25% (twenty five percent) of the total capital of the bank.

v. Penalties for Non-Performance

Because the fundamentals of these proclamations are to safeguard the whole economy and achieve sustained economic growth through fostering monetary stability and sound financial system, not to comply with it and/or with the directives would result in a consequence. As it is clearly indicated in proclamation No. 86/1994, penalties could range from fine in Birr and imprisonment up to cancellation of licenses.

6.3 Check Your Progress

1. List down at least 5 major activities of banking sectors?

6.3.2 Insurance Sectors in Ethiopia

Dear learner, By now I hope you have understand what insurance do and their types. Can you list some of the roles played by the insurance in our economy?

_____

_____

As it have been discussed earlier, the term insurance can have different definitions. However, the main purpose of insurance is helping individuals in case of financial problems resulting from misfortune by pooling such risks from many people. The commercial code of Ethiopia defines insurance from the legal point of view as *"contract whereby a person called the insurer undertakes against payment of one or more premiums to pay to a person, called the beneficiary, a sum of money where a specified risk materializes.*"

Accordingly, the Banking and insurance proclamation no. 86/1994 were issued to this effect declaring that the minimum capital requirement for General insurance to be Birr 3 million and for life insurance Birr 4 million. Gradually many private insurance companies were established.

6.2.2.1 The role of insurance in the economy

Insurers are not simple pass-through mechanisms for diversifying risk under which the unfortunate few who suffer losses are indemnified from the funds collected. It has so many benefits.

The Mechanisms by which insurance contribute to economic growth, include:

(i) Promote financial stability

By indemnifying those who suffer unexpected loss or harm, insurance helps stabilize the financial situation of individuals, families and organizations. The assurance that their resources can be protected encourages individuals and firms to create wealth. Without insurance, individuals and families could become financially destitute and forced to seek assistance from relatives, friends, or government; organizations may suffer financial loss (thereby reducing their contribution to the economy- employees lose jobs, suppliers lose business, customers forgo the opportunity to buy from the firm, government loses revenue).

(ii) Substitute for and complement Government security programs

Private insurance relieves pressure on social welfare systems by reducing welfare payments, thereby reserving Government resources for essential social security and other purposes, and allowing individuals to tailor their security programs to their own preferences.

(iii) Facilitate trade and commerce

Insurance coverage may be a condition for engaging in trade activities with high risk of failure- e. g. funding by venture capitalists requires adequate coverage of tangible assets and the entrepreneurs' lives (because entrepreneurs are more likely to create and expand their business ventures if they can secure adequate protection).

Insurance serves as “lubricant” of trade-without wide choice of insurance products and constant service, insurance inadequacies could stifle trade and commerce.

(iv) Mobilize savings

Insurers enhance financial system efficiency by:

a) Reducing transaction costs associated with bringing savers and borrowers together insurers collect small premiums from individuals and invest them as loans to business and other ventures (thereby avoid time consuming and costly direct lending and investing by individual policyholders); insurers can acquire information necessary to make sound investments more efficiently than individuals, the benefits of which are passed to policyholders;

b) Creating liquidity (reduce the illiquidity inherent in direct lending) - although insurers invest long-term (i.e. borrowers need not repay immediately) policyholders still have immediate access to loss payments. If individuals were to undertake equivalent direct lending, the proportion of their wealth in long-term illiquid assets would be high.

c) Facilitate economies of scale for investment- projects may be large relative to available finance but may also involve economies of scale, promote specialization, and stimulate technological innovation. Insurers (contractual savings institutions-life insurers and private pension funds-in particular, which take longer-term view, unlike banks which collect short-term deposits) can meet the financing need by amassing large sums from small premium payers (thereby enlarge the set of feasible investment projects and encourage economic efficiency) their long-term liabilities and stable cash flows are ideal sources of long-term finance.

(v) Enable risk to be managed more efficiently

Intermediaries price risks and provide for risk transformation, pooling, and reduction.

a) Risk pricing- risk is priced at two levels:

- ✓ Insurers evaluate the loss potential of businesses, persons, and property for which they might provide insurance (the greater the expected loss, the higher the price). In the process, they cause the insured's to quantify the consequences of their risk-causing and risk-reduction activities, thus deal with risk more rationally.

- ✓ Insurers evaluate creditworthiness of their borrowers and those businesses in which they invest. These may better inform business owners, potential investors, customers, creditors, employees, and other stakeholders about the firm's overall risk characteristics, (thus make better informed decisions).

b) Risk transformation- Insurance permits businesses and individuals to transform their own needs better. Property, liability, loss of income, and other risk exposures can be transferred to an insurer for a price. In the process, the insured's risk profile changes. Life insurers also tailor contracts to the needs of different clients (thereby) helping individuals and business transform the characteristics of their savings to their desired profiles of liquidity, security, and other risk.

c) Risk pooling -occurs at two levels:

- ✓ In aggregating individual risk exposures, insurers can make reasonably accurate estimates of the pool's overall loss-the larger the number of insureds, the more stable and predictable is the insured's experience, leading to a reduction in volatility, hence permitting insurers to charge small premiums and maintain more stable premiums.
- ✓ Insurers benefit from pooling through their investments-in providing funds to a broad range of enterprises, individuals, and others, they diversify their investment portfolios (The default of a few borrowers is likely to be offset by the many sound investments).

(vi)Encourage Loss Mitigation measures

Insurers have incentive to help insured prevent and reduce losses. Insurers' detailed knowledge about loss-causing events, activities, and processes affords them a comparative advantage in loss assessment and control.

Insurers support loss control programs (e.g., fire prevention; occupational health and safety activities; industrial loss prevention; reduction in automobile property damage, theft, and injury; etc.), which reduce losses to businesses and individuals and complements good risk management (thereby benefiting society as a whole).

(vii) Foster Efficient Capital Allocation

Because of the substantial information they gather to conduct evaluation of firms, projects, and mangers (in deciding whether and at what price to issue insurance, in their role as lenders and investors) and their better capacity to process it, insurers have an advantage and are better at allocating financial capital efficiently. That is they will choose to insure and to provide funds to the soundest and most efficient firms, projects, and mangers.

6.2.2.2 Current regulations of Ethiopian Government concerning Insurance Sectors

Dear learner, from the previous reading on commercial banks, related to regulation, can you say something about the applicable regulation on insurances companies?

_____

_____

The first regulations governing insurance were enacted to protect insurers against fraudulent action on the part of the insured. It is only because of the appearance of compulsory insurance and the increasing level of complexity of insurance contracts, that legislators concern themselves with protecting the interests of the insurance consumers.

The contractual relationship between the insured and the insurer reveals a potential imbalance. In other words, the insured pays his consideration (premium payment) at the very beginning of the contract. But before the insurer is called to perform his part, time may change the security profile of the insurer. In view of the economic importance of insurance, this has led Government Authorities to enact regulations that should guarantee the long term viability of insurers.

Regulating the insurance industry does not seem a question of choice for Ethiopia-rather a must to do. Some individuals who are participating in this industry believe that Ethiopian insurance companies are working at *the capital of other country's insurance capital which requires legal protection*. Besides, because the attitude, awareness of the public and information flow about insurance activities is at a lower level there is no any better than developing the trust/confidence of the people on insurance companies through regulating their activities. In our country proclamation 86/1994 is proclaimed to provide for the licensing and supervision of insurance business.

Let us summarize the basic regulations in to the following categories:

1 Regulation related to licensing

Historically, fixed capital requirements have been specified in most countries insurance statues to ensure that applicants seeking licenses to conduct insurance business have sufficient capital to support their operational activities. In accordance with Article 4 of proclamation 86/1994 the minimum paid up capital requirement for non life and life insurance business in Ethiopia is Birr 3,000,000 and Birr 4,000,000 respectively. For composite insurers (undertaking both life and non-life) the requirement is Birr 7,000,000. In accordance with Article 6, application for the grant of a license shall be accompanied by Memorandum and Articles of Association, insurance policy forms and such other particulars as may be prescribed by directive to be issued by the National Bank.

2. Regulation related to reserves and solvency

Some reserves are specified and compulsory by law: i.e., statutory deposit and various technical provisions. According to Article 4 of proclamation 86/1994:

i. Every insurer shall, in respect of each main class of insurance business he carries on in Ethiopia deposit and keep deposited with the bank an amount equal to fifteen percent (15%) of his paid up capital in cash or Government securities.

ii. The deposit specified in sub-article (1) above shall be held to the credit of the insurer provided that the aforesaid deposit or any part there of shall not be withdrawn except with the written permission of the National Bank: nor shall such deposit be used as a pledge or security against any loan or overdraft.

The law also requires 10% of annual net profit to be deposited into a legal reserve account. Insurers can also make additional reserves as prudent underwriting practice dictated them. All these legally and practically required reserves are aimed at ensuring the financial strength of an insurer in discharging its financial commitments

To be solvent an insurance company's total admitted assets have to exceed its total admitted liabilities by a certain specified margin in line with the statutory requirement on force.

According to the definition of Article 20 of proclamation No.86/1994, an insurer carrying on general insurance business shall be deemed insolvent if the value of the insurer's assets does not exceed the amount of his liabilities by whichever is the greater of the amount of the statutory deposit (i.e. 15% of the paid up capital), or 15% of the net premium written by the insurer in his last preceding financial year.

3. Disclosure Regulation

As per Article 18 of the proclamation, the balance sheet, profit and loss account and revenue account of every insurer shall be audited annually by an auditor. A copy of every report of the auditor shall be sent to the Bank not later than ninety (90) days after the end of its financial year. In addition, according to Directive No SIB/17/98, each insurer shall submit to the supervision department of the National Bank of Ethiopia separate quarterly reports for general and long-term insurance business within twenty days after the end of each quarter.

4. Prohibitions or restrictions

Usually large funds remain under the custody of insurers and invested to produce additional returns. Under competitive pressure this additional income may enable the insurer to charge lower rates than would be usual, and make the insurers, products attractive here by improving its overall profitability. The management of these funds is thus very important both to insurers and insured and may also play a significant role in the national economy. Appropriate regulations to channel these funds so as to target developmental areas of the economy may contribute to the overall economic development of the country. Hence the National Bank of Ethiopia (NBE) Issued Directive No. SIB25/2004 which Limits on investment of insurance funds as follows:

i. General Insurance Funds

The General Insurance funds of an insurance company can be invested in Treasury Bills and bank deposits not less than 65% of admitted assets; provided, however, that aggregate bank deposits (checking, savings and time deposits) held with any one bank shall not exceed 25% of total admitted assets; investment in company shares not exceeding 15% of total admitted assets; In real estate not exceeding 10% of total admitted assets; and 10% of admitted assets in investments of the insurance company's choice.

ii. Long –term Insurance Funds

The Long-term Insurance funds of an insurance company can be invested in Treasury Bills/Bonds and bank deposits not less than an aggregate of, 50% of total admitted assets; provided, however, that aggregated deposits (checking, savings and time deposits) held with any one bank shall not exceed 25% of total admitted assets; Investments in company shares not exceeding 15% of total admitted assets; investments in real estate not exceeding 25% of total admitted assets; and 10% of total admitted assets in investments of the insurance company's choice.

In addition, Article 29 sub article 1 of the proclamation sets Restriction on loans, Advances, etc, by an insurer.

✓ That is, Unless provided otherwise by regulations and directives issued hereunder, no insurer shall grant any loan, advance, financial guarantee or other credit facility either on hypothecation of property or on personal security or otherwise, except loans on life polices issued by him within their surrender value, to any shareholder of the insurer or to any director manager, actuary, auditor or officer working for the insurer or to any insurance auxiliary or to any other person connected with the said persons.

5. Other regulations

☞ ***Re-Insurance:***

In Ethiopia, reinsurance contracts are subject to supervision by NBE. The bank may give advice and information about re-insurers but the task of monitoring (screening) the security of re-insurers falls principally upon ceding companies, since it is up to them to choose their re-insurers.

☞ ***Amalgamation:***

Article 40 requires that no insurer shall amalgamate with or takeover the insurance business of another insurer except with the prior approval of the NBE.

☞ ***Certification of Soundness of Terms of Insurance Business:*** According to Article 36:

The National Bank shall ensure that the terms of insurance policies safeguard the rights of policy-holders, under the laws of Ethiopia.

- At any time, the NBE may take any modifications to insure that premium rates, advantages, terms and conditions offered are workable and sound.

6.4 Check Your Progress

1. Explain the mechanisms by which insurance contribute to economic growth?
2. Explain in brief the way commercial code of Ethiopia defiance insurance?

6.3. SUMMARY

A financial system is defined as the collection of markets, individuals, laws, polices, systems, conventions, techniques and institutions through which bonds, stocks, and other securities are traded, interest rates are determined and financial services are provided and delivered. The primary task of the financial system is to move scarce loanable funds from those who save to those who borrow to buy goods and services and to make investments so that the economy can grow and increase the standard of living enjoyed by citizens. The end users of this system are people and firms whose desire is to lend and to borrow.

When we come to the origin of financial markets and institutions in land of ours, the agreement that was reached in 1905 between Emperor Minilik II and Mr. Ma Gillivray, representative of the British owned National Bank of Egypt marked the introduction of modern banking in Ethiopia. The National Bank of Ethiopia with more power and duties started its operation in January 1964.

On the other hand, modern forms of insurance service, which were introduced in Ethiopia by Europeans, trace their origin as far back as 1905 when the Bank of Abysinia began to transact fire and marine insurance as an agent of a foreign insurance company. The first remarkable event that the Ethiopian insurance market witnessed was the promulgation of proclamation No. 281/1970. This proclamation was issued to provide for the control & regulation of insurance business in Ethiopia. It is peculiar in that it created an Insurance Council and an Insurance Controller's Office.

Self-Assessment Questions 6

Part I: Multiple Choices

Direction: Choose the best answer from the given alternatives. (10 marks)

1. **I**f the printing of money will be beyond the economy's capacity to produce and services, then:
   - A. It would bring on severe inflation,
   - B. It disrupt the payment mechanism,
   - C. Bring business activity to a halt,
   - D. All of the above,
   - E. None of the above.
2. As per the revised directive of SBB No. 24/99 every existing bank shall at all times maintain minimum unimpaired capital of :
   - F. Seventy five million birr,
   - G. Not less than 25% (twenty five percent) of its net profit,
   - H. Not less than 75% (seventy five percent) of its net profit,
   - I. Up to 15% (fifteen percent) of all birr and foreign currency deposit liabilities held in the form of current, saving and time deposits,
   - J. None of the above.
3. The insured transfers risk to the insurer and to this effect, he will
   - K. Assumes or retains risks,
   - L. Provides protection against financial loss,
   - M. It depends on variety of situations as specified in their binding contract, accordingly, insurances security against financial hardship,
   - N. All of the above,
   - O. None of the above.
4. Pooling of losses doesn't imply
   - P. As the average loss is substituted for actual loss,
   - Q. The sharing of losses by the entire group,
   - R. Prediction of future losses with some accuracy based on the law of large number,
   - S. All of the above,
   - T. None of the above.
5. Which one of the following statement is not true?

U. All microfinance institutions (MFls) in Ethiopia are depository institutions.

V. Borrowers of micro finance are usually required to be savers.

W. MFI's operating costs as well as administrative cost per loan are lower than the conventional bank's.

X. All of the above.

Y. None of the above.

Part II: MATCHING

Direction: Match statements under 'Column One' with the correct terms under 'Column Two'

	Column One		Column Two
1	Paid to eligible survivors if the deceased had less than 10 years of service and contributions and was not eligible for a pension.	A	Survivor pension
2	Providing liquid funds to those financial institutions squeezed by severe liquidity pressures.	B	Indemnification
3	The spreading of losses incurred by the few over the entire group.	C	Risk transfer
4	One that is unforeseen and unexpected and occurs as a result of chance.	D	Disability settlement
5	Prudential operating policies and procedures for credit and investment management including single individual, company or group exposure limits.	E	Subrogation
6	A pension fund that doesn't have enough investment to cover its pension obligations is said to be have a_____.	F	Financial Institutions
7	The deceased met the contribution conditions for the old-age pension or was a pensioner at the time of death.	G	A fortuitous loss
8	The insured is restored to his or her approximate	H	One of the key core

	financial position prior to the occurrences of the loss.		principles of MFIs
9	The insured must be assessed as incapable of normal gainful employment and have less than 10 years of service and contributions.	I	Lender of the last resort
10	Substitution of the insurer in place of the insured for the purpose of claiming indemnity from a third person for a loss covered by insurance.	J	Shortfall
		K	Disability pension
		L	Survivor settlement
		M	Pooling of losses
		N	None of the forgoing

Part III: True or False

Direction: Say true or false for the following statements.

1. A National Bank is an agency of Government-which is concerned with maximizing its profit.

2.The role of commercial banks is unique among all the other financial institutions. 3.Following the liberalization of interest rate by the NBE in January 2, 1995 every bank are mandated to set their own lending and deposit rates given the maximum deposit rate sated by the NBE.

4.The overall open foreign currency position of each bank at the close of business day shall not exceed 15% (fifteen percent) of its total capital.

5.Indemnity is important as it deals in part with moral hazard.

ANSWER KEY

Answer to check your progress

Chapter 1

1.1Check your progress

1) A financial system is defined as the collection of markets, individuals, laws, polices, systems, conventions, techniques and institutions through which bonds, stocks, and other securities are traded, interest rates are determined and financial services are provided and delivered. The financial system consists of the group of institutions in the economy that helps to match one person's saving with another person's investment.

2) The financial system consists of the group of institutions in the economy that helps to match one person's saving with another person's investment. Financial system: comprises of: borrowers, lenders and financial, intermediaries. This can be split into: individuals, firms, institutions, government agencies, financial instruments, financial services, and financial markets conventions.

1.2 Check your progress

1) A financial market is a market in which trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds, and commodities include precious metals or agricultural goods.

The financial system is complex, comprising many different types of private sector government. Companies, and investment banks, all of which are heavily regulated by the financial institutions, including banks, insurance companies, mutual funds, finance.

2) An auction market is some form of centralized facility (or clearing house) by which buyers and sellers, through their commissioned agents (brokers), execute trades in an open and competitive bidding process. An auction market is typically a public market in the sense that it open to all agents who wish to participate.

3) In finance, financial markets facilitate:

- ✓ The raising of capital (in the capital markets)
- ✓ The transfer of risk (in the derivatives markets)
- ✓ Price discovery
- ✓ Global transactions with integration of financial markets
- ✓ The transfer of liquidity (in the money markets)
- ✓ International trade (in the currency markets) and are used to match those who want capital to those who have it.
- ✓

4) A financial institution is an institution whose primary source of profits is through financial asset transactions. Examples of such financial institutions include discount brokers (e.g., Charles Schwab and Associates), banks, insurance companies, and complex multi-function financial institutions such as Merrill Lynch.

1.3 Check your progress

1) The following are the major functions of financial system:

1. Borrowing and Lending
2. Price Determination
3. Information Aggregation and Coordination
4. Risk Sharing
5. Liquidity
6. Efficiency

2) The sharing of loss can be accomplished through risk diversification and risk pooling.

Risk Diversification: Financial markets permit savers to diversify their asset portfolios by purchasing financial assets from many different borrowers who face separate types of risks. And ,Risk Pooling: conversely, financial markets permit borrowers to transfer their risk to lenders by issuing financial assets to a pool of savers that then collectively shares the risk (e.g., default) burden.

3) It is difficult to get information about the credit worthiness of individuals or small businesses, as well as to seek out potential borrowers or lenders. The specialized information gathering resources and skills of financial intermediaries help to reduce the costs of acquiring information about potential borrowers and lenders.

4) Primary markets are securities markets in which newly issued securities are offered for sale to buyers. Secondary markets are securities markets in which existing securities that have previously been issued are resold. The initial issuer raises funds only through the primary market. Primary market transactions provide funds to the initial issuer of securities; secondary market transactions do not.

Self Assessment Questions 1

Part I	**Part II**
1 E	1. T
2 B	2 T
3 A	3 T
4 E	4 T
5 A	5 T

Chapter 2

2.1 Check your progress

1) Financial intermediation consists of "channeling funds between surplus and deficit agents''. A financial intermediary is an entity that connects surplus and deficit agents. The classic example of a financial intermediary is a bank that transforms bank deposits into bank loans. As such, financial intermediaries channel funds from people who have extra money (savers) to those who do not have enough money to carry out a desired activity (borrowers).

2) Surplus units: Economic agents for whom receipts are higher than expenditures are called surplus units

3) Deficit units: Those who spend in excess of what they receive are called deficit units, dissavers, or ultimate borrowers.

2.2 Check your progress

1) Adverse selection is the problem created by asymmetric information before the transaction occurs. Adverse selection in financial markets occurs when the potential borrowers who are the most likely to produce an undesirable (adverse) outcome—the bad credit risks—are the ones who most actively seek out a loan and are thus most likely to be selected. Moral hazard is the problem created by asymmetric information after the transaction occurs. Moral hazard in financial markets is the risk (hazard) that the borrower might engage in activities that are undesirable (immoral) from the lender's point of view, because they make it less likely that the loan will be paid back.

2) The followings are the major functions of financial intermediaries:

1-Monitoring costs would be very high for individuals making loans or supplying capital directly to borrowers e.g. companies or other individuals, vs. financial intermediaries.

2-Financial claims like private loans might be very illiquid, and there might be very high transaction costs for trading the financial claims. Transaction cost, the time and money spent in carrying out financial transactions, are a major problem for people who have excess funds to lend.

3-Individuals would be exposed to a high level of risk, undiversified investment portfolios. Risk is uncertainty about the returns investors will earn on assets. By purchasing a large number of different assets issued by a wide range of borrowers, financial intermediaries use diversification to help with risk sharing.

Asymmetric information: Adverse Selection and Moral Hazard. One party often does not know enough about the other party to make accurate decisions. This inequality is called asymmetric information. For example, a borrower who takes out a loan usually .

3) Depository institutions are financial intermediaries that accept deposits from individuals and institutions and make loans. The study of money and banking focuses special attention on this group of financial institutions, because they are involved in the creation of deposits, an important component of the money supply.

Self Assessment Questions 2

Part I	**Part II**
1 D	1 T
2 E	2 T
3 B	3 T
4 D	4 T
5 C	5 T

Chapter 3

3.1 Check your progress

1)Financial markets (bond and stock markets) and financial intermediaries (banks, insurance companies, pension funds) have the basic function of getting people together by moving funds from those who have a surplus of funds to those who have a shortage of funds .

2) Financial markets perform the essential economic function of channeling funds from households, firms, and governments that have saved surplus funds by spending less than their income to those that have a shortage of funds because they wish to spend more than their income. Those who have saved and are lending funds, the lender-savers, and those who must borrow funds to finance their spending, the borrower-spenders.

3) Financial markets have an important function in the economy. They allow funds to move from people who lack productive investment opportunities to people who have such opportunities. Thus financial markets are critical for producing an efficient allocation of capital, which contributes to higher production and efficiency for the overall economy.

3.2 Check your progress

1) The money market is a financial market in which only short-term debt instruments (generally those with original maturity of less than one year) are traded; the capital market is the market in which longer-term debt (generally those with original maturity of one year or greater) and equity instruments are traded. Money market securities are usually more widely traded than longer-term securities and so tend to be more liquid. The futures market is the market in which securities are traded for future delivery at a specified price. The instruments traded in this market are called futures contracts.

2) Specifically, organized exchanges permit buyers and sellers to trade with each other in a centralized location, like an auction. The other method of organizing a secondary market is to have an over-the counter (OTC) market, An over-the-counter market has no centralized mechanism or facility for trading. Instead, the market is a public market consisting of a number of dealers spread across a region, a country, or indeed the world, who make the market in some type of asset.

3) The spot market is the market in which securities are traded for immediate delivery and payment. The term “immediate” can mean the same day or a week later depending on the particular market. The spot market is also called the cash market.

3.3 Check your progress

1) Financial institutions can be roughly classified into the following four categories: "brokers;" "dealers;" "investment bankers;" and "financial intermediaries."

2) A broker is a commissioned agent of a buyer (or seller) who facilitates trade by locating a seller (or buyer) to complete the desired transaction. A broker does not take a position in the assets he or she trades -- that is, the broker does not maintain inventories in these assets. Like brokers, dealers facilitate trade by matching buyers with sellers of assets; they do not engage in asset transformation. Unlike brokers, however, a dealer can and does "take positions" (i.e., maintain inventories) in the assets he or she trades that permit the dealer to sell out of inventory rather than always having to locate sellers to match every offer to buy.

Also, unlike brokers, dealers do not receive sales commissions. Rather, dealers make profits by buying assets at relatively low prices and reselling them at relatively high prices (buy low - sell high).

3) Financial intermediaries are financial institutions that engage in financial asset transformation. That is, financial intermediaries purchase one kind of financial asset from borrowers -- generally some kind of long-term loan contract whose terms are adapted to the specific circumstances of the borrower Types of financial intermediaries include: Depository Institutions (commercial banks, savings and loan associations, mutual savings banks, credit unions);Contractual Savings Institutions (life insurance companies, fire and casualty insurance companies, pension funds, government retirement funds); and Investment Intermediaries (finance companies, stock and bond mutual funds, money market mutual funds).

3.4 Check Your Progress

1) The correct answer is False. There is no way of knowing what the investor should do without information about the forward price of the franc in terms of the mark. If the 180-day forward price of the mark is above FF 2.5 at, let us suppose, FF 2.8, the investor should sell the mark short because he could buy the marks necessary to fulfill the contract at the time the contract matures for 3 francs less than he would be contracting now to sell them for. If the price of 180-day forward price of the mark is below FF 2.5, he should sell the franc short---he could buy francs in 180 days for less marks he can contract in advance to sell them for.

The main point here is that the potential expected profit from speculation depends on the difference between the forward rate and the spot rate that is expected to rule on the date the forward contract matures. The speculator commits to selling a particular currency in the future at a price in terms of a base currency that is agreed upon now, hoping to be able to purchase that currency spot when the time comes to deliver it at a price below the agreed-upon forward selling price. The actual profit realized will depend on the difference between the agreed-upon forward price and the actual spot price at the future date specified in the forward contract.

Note that the spot price on the date the forward contract is entered into has no bearing on the speculative position, if any, that one should take. There is no reason for it to be the same as the forward price. Indeed, the difference between the forward price and the spot price on the day the forward contract is struck, taken as a proportion of the spot price---defined as the forward discount on the base currency---is determined by the market's assessment of the future time path of the spot price, together with the risk involved in taking a forward position.

2) The correct option is 1. A forward sale of the pound commits the trader to sell pounds for $2.00 each in 30 days. When that time comes, she expects to be able to purchase those pounds for $1.90 each, for a net gain of 10 cents per unit.

The trick in getting the right answer to questions like this one is to figure out which currency is expected to depreciate in the future relative to its forward value. That is the currency that should be sold forward. Selling it forward is the same thing as buying the other currency forward. Our trader can be thought of as purchasing dollars forward for .50 pounds each in the expectation that she can sell these dollars spot on the agreed-upon day of purchase for .526 pounds.

Return to Lesson

3) The correct answer is False. If enough market participants disregard the risk of taking forward mark/dollar positions, the statement would be true. But we can't assume that there is no risk premium. As a result, the observed forward discount on the dollar may simply reflect the risk of taking a speculative position on it.

Suppose that the entire forward discount represents an allowance for risk. This means that a trader who has a forward commitment to sell marks for dollars needs to have a forward price of the mark in terms of the dollar 2 cents or 4.35 percent above the spot price he expects to rule on the maturity date of the forward contract to compensate him for the risk of holding dollars forward. This would imply, of course, that the trader expects no change in the dollar/mark exchange rate during the life of the forward contract.

4) The correct choice is option 4. A forward sale of the Australian dollar commits the trader to buy Swiss francs for 0.81 Australian dollars each in 90 days. When that time comes, he expects to be

able to sell those francs for 0.90 Australian dollars each, for a net gain of 9 Australian cents per unit. Notice that a forward sale of the Australian dollar is equivalent to a forward purchase of the Swiss franc in this case. The trader is short on Australian dollars and long on Swiss francs.

3.5 Check Your Progress

1-The followings are some of the purpose of capital market:

- ✓ Promotes a culture of thrift or savings
- ✓ mobilizes long-term savings to finance investment
- ✓ To provide risk capital in the form of equity or quasi equity to entrepreneurs.
- ✓ To encourage broader ownership of productive assets
- ✓ Improves access to finance of different types of users by providing flexibility for customization.

2- We can put the difference between money and capital market as follows:

Money Market	Capital Market
- market for short term fund	- market for long term funds
- deal with debt securities	- deal with equity securities
- have low risk and low return	- have high risk and high return
- low speculation due to short maturity	- high speculation due to long maturity

3- Without credit rating agencies, bond markets and credit markets might not develop, or would be very thin. Information about creditworthiness would be costly for individual or small investors. For example in US Standard and Poor's and Moody's are the two largest bond rating agencies, using 9 letter grades to assign overall credit risk, and then 1, 2, or 3s for Moody's or +/- for S&P. For example, a staff of 1,250 credit analysts, accountants, and economists at S&P conduct research on credit risk for companies, governments, and even countries.

3.5 Check your progress

1) Where

FV=1million

Po= 990,000

D= 30 days

$$\frac{1{,}000{,}000 - 990{,}000}{1{,}000{,}000} \times 360/30 = 12\ \%$$

2) CD Value

1,000,000 (1+ 0.05/4) = the holder will receive 1,012,500 Br

3.6 Check your progress

1) Cross-Listing of Shares is when a firm (MNC) lists/sells its shares on one or more foreign exchanges in addition to the domestic exchange.

-Increased liquidity, broader investor base. Increased global demand may support a company and it products. Consumers who like the company's products may be more

-Cross-listing improves name recognition globally in new capital markets. May make it easier in future to raise additional equity or debt capital globally, get a higher price for stock, lower interest rate for debt.

-Company may benefit as more consumers and investors become familiar with the higher stock price.

2) A stock Market Index is composite value of a group of stocks traded on secondary market and the following lists are index whereby stock markets can be traded:

a) Dow Jones Industrial Average (DJIA)

b) NYSE Composite Index

c) S&P 500 Index

d) NASDAQ Composite Index

e) MSCI - Morgan Stanley Capital International

Self Assessment Questions 3

Part I	Part II	Part III
1 E	1 E	1 T
2 D	2 L	2 T
3 C	3 G	3 F
4 B	4 K	4 F
5 A	5 J	5 F
	6 F	
	7 B	
N	8 I	
	9 N	
	10 A	

Chapter 4

4.1 Check Your Progress

1) With the help of their functions, the financial institutions transfer money or funds to various tiers of economy and thus play a significant role in acting upon the domestic and the international economic scenario. For carrying out their business operations, financial institutions implement different types of economic models.

2 Some of the financial institutions serve as mediators in share markets and debt security markets. These institutions include: Banks, Stock Brokerage Firms , Non Banking Financial Institutions, Building Societies , Asset Management Firms, Credit Unions and Insurance Companies. Financial institutions deal with various financial activities associated with bonds, debentures, stocks, loans, risk diversification, insurance, hedging, retirement planning, investment, portfolio management, and many other types of related functions.

3. Commercial banks and other similar institutions.

Check Your Progress 4.2

1. The major types of depository financial institutions are: Commercial banks, Saving and Loan Associations, Mutual Savings Banks, Micro Finance Institutions (MFIs), and Credit Unions.

2. Commercial banks play an indispensable roll in the economic activities of every country. Accordingly, the following are among the main functions of the commercial banks:

- ✓ They process payments with the help of online banking, telegraphic transfer, debit card, and other methods;
- ✓ They issue banknotes, such as promissory notes;
- ✓ Acceptance of funds on term deposits;
- ✓ Issuance of bank checks and bank drafts;

Offering performance bonds, guarantees, letters of credit, and other types of documents related to underwriting commitments for securities.

3. Depository institutions are popular financial institutions for the following reasons:

- ✓ They offer deposit accounts that can accommodate the amount and liquidity characteristics desired by most surplus units.
- ✓ They repackage funds received from deposits to provide loans of the size & maturity desired by deficit units.
- ✓ They accept the risk on loans provided.
- ✓ They have more expertise than individual surplus units in evaluating the credit worthiness of deficit units.
- ✓ They diversify their loans among numerous deficit units and therefore can absorb defaulted loans better than individual surplus units could.

Check Your Progress 4.3

1. Some of the most important characteristics of a savings and loan association are:

5. It is generally a locally owned and privately managed home financing institution.
6. It receives individuals' savings and uses these funds to make long-term amortized loans to home purchasers.
7. It makes loans for the construction, purchase, repair, or refinancing of houses.

It is state or federal chartered.

2**.** Credit unions typically pay higher dividend (interest) rates on shares (deposits) and charge lower interest on loans than banks. Credit union revenues (from loans and investments) do, however, need to exceed operating expenses and dividends (interest paid on deposits) in order to maintain capital and solvency. Often credit unions have a lower cost of funds than typical commercial banks, due to a higher proportion of non/low interest bearing deposits.

3. Credit provision (Small size credit/loans) to:

- ✓ Rural and urban poor households;
- ✓ Petty traders;
- ✓ Handcraft producers;
- ✓ Unemployed youth and women ...etc.

4. Mutual savings banks are much like savings and loans, but are owned cooperatively by members with a common interest, such as company employees, union members, or congregation members

Check Your Progress 4.4

1. Unlike depository institutions, non-depository institutions do not accept checkable deposits. With one exception that will be noted shortly, you cannot simply write a "check" to withdraw funds from a non-depository institution

2. Pension plans may be regulated by governments or financial institutions. A trustee is appointed to hold the assets in trust for the benefit of the plan members. Usually the trustee is also the custodian, which holds the plan investments. Pension plans usually hire an outside investment manager to invest the plan assets.

3. From the viewpoint of the society, insurance is an economic device for reducing and eliminating risk through the process of combining a sufficient number of homogenous exposures into a group to make the losses predictable for the group as a whole. From the viewpoint of the insured, insurance is a transfer device.

Self Assessment Questions 3

Part I	**Part II**	**Part III**
1 E	1 F	1 T

2 C	2 J	2 F
3 B	3 L	3 T
4 E	4 G	4 F
5 D	5 H	5 F
	6 A	
	7 O	
N	8 M	
	9 D	
	10 I	

Chapter 5

Check Your Progress 5.1

1 The initial focus, and still the central element, of regulatory system is to solve the problem of the uninformed investor through company disclosure and transparency of trading markets.

2 Inefficiency ultimately imposes costs on the community through higher taxes and charges, poor service, uncompetitive pricing or slower economic growth. Clearly there must be limits on the applicability of this rational for regulation.

3 There are restrictions on what financial intermediaries are allowed to do and what assets they can hold. Before you put your funds into a bank or some other such institution, you would want to know that your funds are safe and that the bank or other financial intermediary will be able to meet its obligations to you. One way of doing this is to restrict the financial intermediary from engaging in certain risky activities.

For example some counties legislation separates commercial banking from the securities industry so that banks could not engage in risky ventures associated with this industry.

4. The first case for regulation to prevent systemic instability arises because of certain financial promises have an inherent capacity to transmit instability to the real economy, inducing undesired effects on output, employment and price inflation

Self Assessment Questions 5

Part I	Part II	Part III
1 E	1 K	1 F
2 A	2 J	2 T
3 C	3 G	3 T
4 B	4 L	4 F
5 C	5 M	5 F
	6 F	
	7 B	
	8 C	
	9 M	
	10 D	

Chapter 6

Check Your Progress 6.1

1.The second, a proclamation to provide for the Licensing and Supervision of Banking Business No. 84/1994, which sets out the conditions under which commercial banks can be licensed and the supervisory requirements they should observe in the course of their operation.

2. The National Bank of Ethiopia was entrusted with the following responsibilities:

- ✓ To regulate the supply, availability and cost of money and credit;
- ✓ To manage and administer the country's international reserves;
- ✓ To license and supervise banks and hold commercial banks reserves and lend money to them;
- ✓ To supervise loans of commercial banks and regulate interest rates;
- ✓ To issue paper money and coins;
- ✓ To act as an agent of the Government; and
- ✓ To fix and control the foreign exchange rates

Check Your Progress 6.2

1- First changes in money supply are closely linked to changes in economic activity. To this end, if the National Banks carefully controls the rate of growth of money, it can influence the growth rate of the economy as whole.

Second, in the absence of effective controls, money in the form of paper notes or bank deposits could expand virtually without a limit. The marginal cost creating additional units of money is close to zero.

2-It is believed that insurance service was started in ancient China and Greek. The code Hammurabi, a collection of Babylonian laws of the 1700's B.C, included a form of credit insurance. Ancient Greek and Roman organizations provide money for burial of their members, old -age pension and disability insurance. During the middle ages, associations formed by aircraft workers offered the same type of insurance as well theft insurance to their members.

Check Your Progress 6.3

1)

Control of the money

Stabilizing financial markets (Regulation and supervision)

Lender of the last resort

Providing information to the public

Maintaining and improving the payments mechanism

2)The major activities/role of commercial banks is illustrated below

- ✓ Deposit mobilization
- ✓ Granting Credit/Loans
- ✓ Collection of loans
- ✓ Interest rate development
- ✓ Banks deposit at NBE
- ✓ Treasury bills market
- ✓ Foreign exchange transaction

Check Your Progress 6.4

1) Promote financial stability

- ✓ Substitute for and complement Government security programs
- ✓ Insurance coverage may be a condition for engaging in trade activities with high risk of
- ✓ Facilitate trade and commerce
- ✓ Mobilize savings
- ✓ Enable risk to be managed more efficiently
- ✓ Foster Efficient Capital Allocation
- ✓ Encourage Loss Mitigation measures

2) *"Contract whereby a person called the insurer undertakes against payment of one or more premiums to pay to a person, called the beneficiary, a sum of money where a specified risk materializes.*

Self Assessment Questions 6

Part I	**Part II**	**Part III**
1 D	1 L	1 F
2 A	2 I	2 T
3 E	3 M	3 F
4 E	4 G	4 T
5 C	5 H	5 T
	6 J	
	7 A	
	8 B	
	9 D	
	10 E	

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