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Chapter 2

The Financial System

Section 1 discusses the biased portrayals of financiers, usually drawn from the media, as unusually greedy or tremendously smart people. This section explains that understanding how the financial system works will help create a more objective perception in the student's mind. Consider showing a clip or reading an excerpt from one of the movies or books discussed in the text, or bring in one of your own. You might also consider showing students some of the complex mathematical models that exacerbated the financial crisis that began in 2007. Here is a starter:

"Wall Street on Trial: Hunting for Scalps," *The Economist* (October 25, 2008), 91.

> "Americans are turning creative as they strive to make sense of the crisis. On October 29th a group of artists will stage a 'literal meltdown' by placing a 1,500 lb (680 kg) ice sculpture of the word 'economy' in Manhattan's Foley Square. The installation will, according to one collaborator, 'metaphorically capture the results of unregulated markets. . . . "

For **Section 2**, brainstorm with students regarding **Figure 2.1**. If they are young and inexperienced students, have them think of their parents' relationships to the financial system, or their financial relationships with friends and family; borrowing/lending money, cars, clothes; and so forth.

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Section 3 is critical. Be sure to have plenty of good examples of adverse selection (flood and avalanche insurance) and moral hazard. Perhaps walk them through the Stop and Think Box so they realize that asymmetric information is part of daily life and not some theoretical abstraction. You might also consider presenting them with the following **classroom case**:

In Britain in 2006, a new type of market facilitator named Zopa began operations.[1] Zopa is essentially a personal loan dealer because it helps lenders to find borrowers, taking the difference between the lending and borrowing interest rate for itself. To learn more, click here: http://www.youtube.com/watch?v=D4vA6yDkr0A or read Jane J. Kim, "Online Lending Gets Easier and Safer," *Wall Street Journal* (28 November 2007), D3. What challenges does Zopa face?

Although defaults have been few so far, they might increase rapidly as crooks come to learn about Zopa's service and website. If regulators do not see fit to regulate the company, numerous competitors could quickly form, cutting into Zopa's spreads and profits. If regulators do intervene, Zopa's cost of doing business could rise dramatically. Nevertheless, the concept is an interesting one that should be monitored.

One of the major functions of the financial system is to reduce the influence of information asymmetries. It monitors financial intermediaries and provides the markets with price information and analysis.

Section 4 deals with financial instruments, also called financial securities. Make sure that after going through this section the students know the different types of legal contracts between individuals, governments, or businesses. Students should be able to connect to the relationship

[1] http://www.zopa.com/ZopaWeb/

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between the maker and the holder of a security. The distinct types like debts, equities, and hybrids should be discussed with the help of examples. In this regard, discussions can be carried out based on bonds (as an example of debt), common stocks (as an example of equities), and convertible bonds (as an example of hybrid).

Figure 2.4 is the key to **Section 5**. Have students try to reproduce it from memory, providing them only with the column and row headings, then walk them through each cell. Providing them with more examples, like that in the two Stop and Think Boxes, may also be necessary. The goal is to induce them to internalize this fundamental terminology.

Much the same can be said for **Section 6**. Reassure students that these are the densest sections of the book. A nice exercise here might be to bring **Figures 2.5**, **2.6**, and **2.7** up to the present.

Section 7 is a conceptually important one. A well-designed, in-class exercise that allows students as investors to trade off among risk, return, and liquidity could drive the point home in an interesting, engaging way. The same can be said for an exercise that has students choose between borrowing from an intermediary or directly in a market. Students should be able to easily differentiate between a risky or a safe asset. The difference between a highly liquid, a liquid, or an illiquid asset should also be discussed along with real-life examples. The exercise can be extended to incorporate regulatory costs, a concept introduced in **Section 8.**

Section 8 encompasses the objectives of financial regulations. Discuss with the students the purposes and operations of the institutions like the Securities and Exchange Commission, the New York Stock Exchange, and the Commodities Futures Trading Commission. Also bring into notice the processes undertaken by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the sundry state banking, and the insurance commissions. The

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examples provided should be able to explain the four major goals of these regulatory bodies. The foremost goal is the reduction of asymmetric information. The second one can be identified as a variant of the first one; it is to protect the consumers from scammers, shysters, and assorted other grifters as well as from the failure of honest but ill-fated or poorly run institutions. The third one deals with the promotion of the financial system competition and its efficiency. The fourth and the final objective is to ensure sound financial system by acting as a lender of last resort.

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Money and Banking 3.0

- Robert E. Wright

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CHAPTER 2
The Financial System

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CHAPTER OBJECTIVES

- Critique cultural stereotypes of financiers.
- Describe the financial system and the work that it performs.
- Define asymmetric information and sketch the problems that it causes.
- List the major types of financial markets and describe what distinguishes between them.
- List the major types of financial instruments or securities and describe what distinguishes them.
- List the major types of intermediaries and describe what distinguishes between them.
- Describe and explain the most important tradeoffs facing investors.
- Describe and explain borrowers' major concerns.
- Explain the functions of financial regulators.

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EVIL AND BRILLIANT FINANCIERS?

Learning Objective

- Critique cultural stereotypes of financiers.

Are bankers, insurers, and other financiers innately good or evil?

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EVIL AND BRILLIANT FINANCIERS?

- A ubiquitous stereotype portrays financiers as evil, brilliant, or both.
- Examples from Popular Culture:
  - Bonfire of the Vanities
    - Sherman McCoy
  - Other People's Money
    - Larry the Liquidator
  - It's a Wonderful Life
    - George Bailey
  - The Merchant of Venice
    - Shylock

Source: https://www.youtube.com/watch?v=iPkJH6BT7dM

- Financiers are not innately good or evil but rather, like other people, can be either, or can be both simultaneously.

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EVIL AND BRILLIANT FINANCIERS?

"But man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and show them that it is for their advantage to do for him what he requires of them."

-Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776

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EVIL AND BRILLIANT FINANCIERS?

"Here's the rule for bargains. 'Do other men, for they would do you.' That's the true business precept."

- Charles Dickens, *Martin Chuzzlewit*, 1843-44

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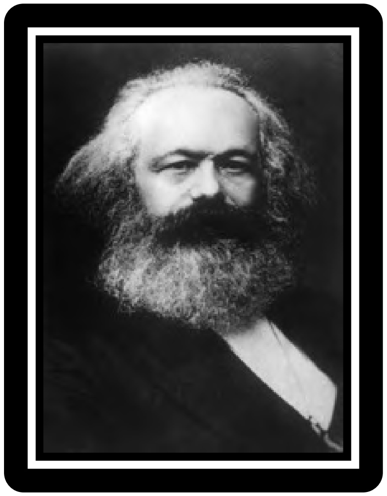
EVIL AND BRILLIANT FINANCIERS?

"When commercial capital occupies a position of unquestioned ascendancy, it everywhere constitutes a system of plunder."

- Karl Marx, *Critique of the Gotha Program*, 1875



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EVIL AND BRILLIANT FINANCIERS?

Key Takeaways

- ✓ Financiers are not innately good or evil but rather, like other people, can be either, or even both simultaneously.
- ✓ While some financiers are brilliant, they are not infallible and fancy math does not make reality.
- ✓ Rather than follow prevalent stereotypes, students should form their own views of the financial system.
- ✓ This important chapter will help students to do that, while also bringing them up to speed on key terms and concepts that will be used throughout the book.

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FINANCIAL SYSTEMS

Learning Objective

- Describe the financial system and the work that it performs.

What is a financial system and why do we need one?

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FINANCIAL SYSTEMS

- A financial system is a densely interconnected network of intermediaries, facilitators, and markets.
  - It serves three major purposes:
    - Allocating capital.
    - Sharing risks.
    - Facilitating all types of trade, including intertemporal exchange.

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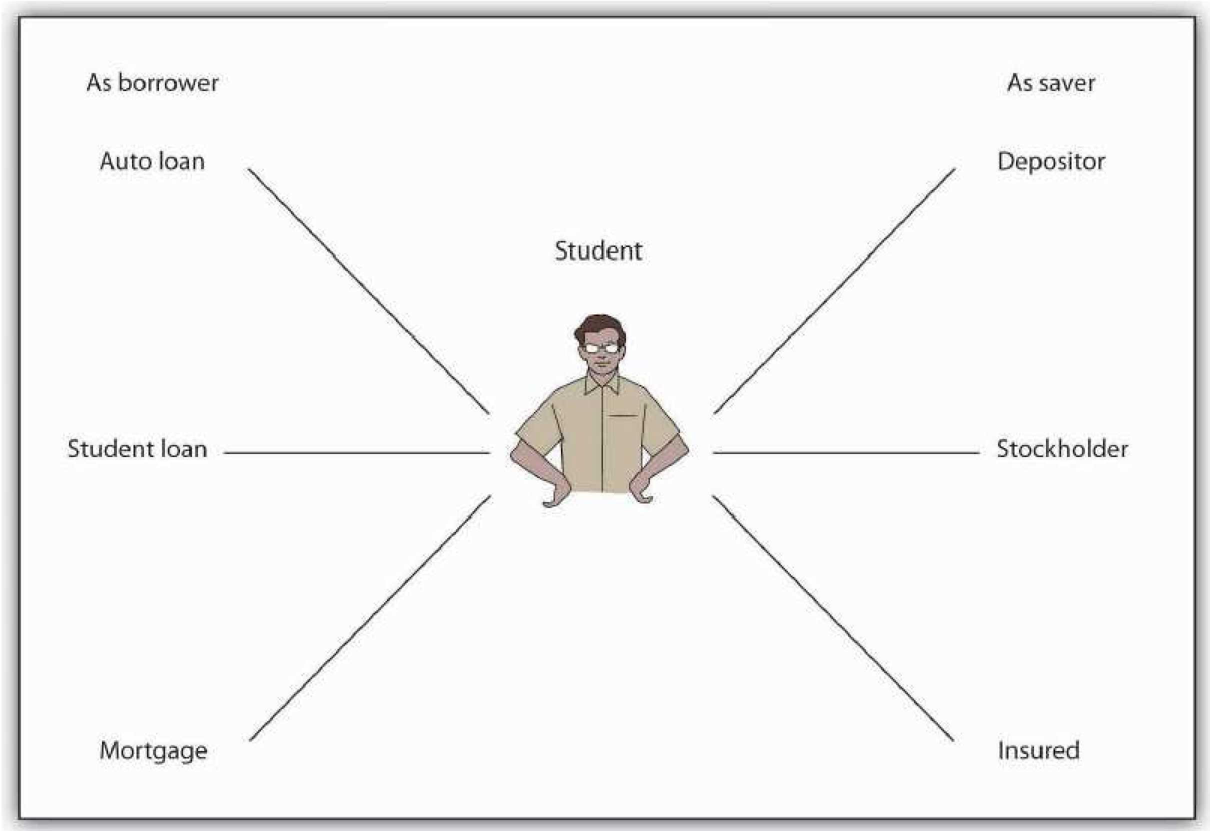
FIGURE 2.1 – THE FINANCIAL SYSTEM AT WORK FOR YOU



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FINANCIAL SYSTEMS

- Internal finance:
  - Financing that comes from the company itself, the plowing of profits back into the business.
- External finance:
  - Obtaining short- or long-term funding from outside sources (those external to the company).
  - Most of the time, people and firms do not have the savings or cash to draw up blueprints, create prototypes, lease office or production space, pay employees, obtain permits and licenses, or suffer the myriad risks of bringing a new or improved good to market.

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WHY DO WE NEED A FINANCIAL SYSTEM?

- The fixed costs of making loans are fairly substantial.
  - Efficient financial companies must exceed minimum efficient scale.
- Lending is most efficiently and cheaply conducted by specialists:
  - They have practice doing so.
  - They tap economies of scale.

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FINANCIAL SYSTEMS

Key Takeaways

- ✓ The financial system is a dense network of interrelated markets and intermediaries that allocates capital and shares risks by linking savers to spenders, investors to entrepreneurs, lenders to borrowers, and the risk averse to risk takers.
- ✓ It also increases gains from trade by providing payment services and facilitating exchange.
- ✓ A financial system is necessary because few businesses can rely on internal finance alone.
- ✓ Specialized financial firms that have achieved minimum efficient scale are better at connecting investors to entrepreneurs than non-financial individuals and companies are.

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ASYMMETRIC INFORMATION, THE REAL EVIL

Learning Objective

- Define asymmetric information and sketch the problems that it causes.

What is asymmetric information, what problems does it cause, and what can mitigate it?

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ASYMMETRIC INFORMATION, THE REAL EVIL

- **Asymmetric Information**:
  - When a seller knows more than a buyer.
- Types of asymmetric information:
  - **Adverse selection**: The fact that the least desirable borrowers and those who seek insurance most desire loans and insurance policies.
    - If unmitigated, lenders and insurers will attract the worst risks.
  - **Moral hazard**: Any postcontractual change in behavior that injures other parties to the contract.
    - If unmitigated, borrowers and the insured will take advantage of lenders and insurers.
- One of the functions of the financial system is to tangle with information asymmetries.
  - Screens insurance and credit applicants and monitors them thereafter.
  - Markets by providing price information and analysis.

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ASYMMETRIC INFORMATION, THE REAL EVIL

- By providing relatively inexpensive forms of external finance, financial systems make it possible for entrepreneurs and other firms to test their ideas in the marketplace.
- They do so by eliminating, or at least reducing, two major constraints:
  - Liquidity: The ease, speed, and cost of selling an asset.
  - Capital: In this context, long-term financing.
- These constraints are reduced in two major ways:
  - Directly via markets
  - Indirectly via intermediaries

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ASYMMETRIC INFORMATION, THE REAL EVIL

Key Takeaways

- ✓ Asymmetric information occurs when one party knows more about an economic transaction or asset than the other party does.
- ✓ Adverse selection occurs before a transaction takes place. If unmitigated, lenders and insurers will attract the worst risks.
- ✓ Moral hazard occurs after a transaction takes place. If unmitigated, borrowers and the insured will take advantage of lenders and insurers.
- ✓ Financial systems help to reduce the problems associated with both adverse selection and moral hazard by screening applicants and monitoring borrowers and the insured.

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FINANCIAL INSTRUMENTS

Learning Objectives

- List the major types of financial instruments or securities and describe what distinguishes them.

What are financial instruments or securities?

What economic function do financial instruments fulfill?

What are the characteristics of different types of financial instruments?

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FINANCIAL INSTRUMENTS

- Legal contracts:
  - Detail the obligations of their makers, the individuals, governments, or businesses that issued them and promise to make payment, as well as the rights of their holders, the individuals, governments, or businesses that currently own them and expect to receive payment.
- Financial instruments, sometimes called financial securities, are legal contracts that come in three major varieties:
  - Debt: A type of maker (called a borrower) promises to pay a fixed sum on a fixed date to a holder (called a lender).
  - Equity: A type of maker (called an issuer) promises to pay a portion of its profits to a holder (called an owner).
  - Hybrid: Has some of the characteristics of debt and some of the characteristics of equity.

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FINANCIAL INSTRUMENTS

- The main function of a legal contract is to specify who owes what to whom, when or under what conditions payment is due, and how and where payment should be made.
  - Today, many financial instruments are electronic accounting entries, but before they were corporeal like with stock certificates.

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confirm/681753?size=huge_jpg

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FINANCIAL INSTRUMENTS

Key Takeaways

- ✓ Financial instruments or securities are contracts that specify who pays whom as well as if, when, how, and where payment is due.
- ✓ Debt instruments are for fixed sums on fixed dates and need to be paid in all events.
- ✓ Equities are ownership stakes that entitle owners to a portion of profits.
- ✓ Hybrid instruments are part debt and part equity or convertible from one into the other.

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FINANCIAL MARKETS

Learning Objective

- List the major types of financial markets and describe what distinguishes between them.

In what ways can financial markets and instruments be grouped?

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FINANCIAL MARKETS

- Financial markets come in a variety of flavors to accommodate the wide array of financial instruments.
  - Primary markets.
  - Secondary markets.
- Financial instruments can be grouped by time to maturity (money vs. capital) or type of obligation (stock, bond, derivative).
  - **Derivatives**: complex financial instruments, the prices of which are based on the prices of underlying assets, variables, or indices.

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FINANCIAL MARKETS

Money Markets

- Used to trade instruments with less than a year to maturity (repayment of principal).

Capital Markets

- Securities with a year or more to maturity.

Derivative Markets

- Where derivatives contracts trade.

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FINANCIAL MARKETS

Brokers

- Facilitate secondary markets by linking sellers to buyers of securities in exchange for a fee or a commission, a percentage of the sale price.

Dealers

- Make a market by continuously buying and selling securities, profiting from the spread, or the difference between the sale and purchase prices.

Brokerages

- Engage in both brokering and dealing and usually also provide their clients with advice and information.

Investment banks

- Facilitate primary markets by underwriting stock and bond offerings, including initial public offerings (IPOs) of stocks, and by arranging direct placements of bonds.

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FINANCIAL MARKETS

Key Takeaways

- ✓ Financial markets can be categorized or grouped by issuance (primary vs. secondary markets), type of instrument (stock, bond, derivative), or market organization (exchange or OTC).
- ✓ Financial instruments can be grouped by time to maturity (money vs. capital) or type of obligation (stock, bond, derivative).

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FINANCIAL INTERMEDIARIES

Learning Objective

- List the major types of intermediaries and describe what distinguishes between them.

In what ways can financial intermediaries be classified?

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FINANCIAL INTERMEDIARIES

- **Financial Intermediaries**:
  - Link investors, lenders, and savers to borrowers, entrepreneurs, and spenders by transforming assets.
- Intermediaries buy and sell instruments with different risk, return, and/or liquidity characteristics.
  - Risk: The probability of loss.
  - Return: The percentage gain or loss from an investment.
- They are categorized according to the type of asset transformations they undertake.
  - Depository institutions issue short-term deposits and buy long-term securities.

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FINANCIAL INTERMEDIARIES

- Insurance companies issue contracts or policies that mature or come due should some contingency occur, which is a mechanism for spreading and sharing risks.
  - Divided between mutual corporations and joint-stock corporations.
- Investment companies include:
  - Pension and government retirement funds.
  - Mutual funds and money market mutual funds.

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FINANCIAL INTERMEDIARIES

Key Takeaways

- ✓ Financial intermediaries, including depository institutions (commercial banks, savings banks, credit unions) and insurers (life, health, property and casualty), can be grouped by the composition of their balance sheets (nature of their assets and liabilities and the asset transformations they undertake) or their ownership structure, the origin of their corporate charters, and/or the identity of their regulators.

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COMPETITION BETWEEN MARKETS AND INTERMEDIARIES

Learning Objective

- Describe and explain the most important tradeoffs facing investors.
- Describe and explain borrowers' major concerns.

What tradeoffs do investors face?

How do borrowers decide whether to use financial markets or intermediaries to obtain the funds they need?

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COMPETITION BETWEEN MARKETS AND INTERMEDIARIES

- Markets and intermediaries fulfill the same needs in different ways.
  - Borrowers or securities issuers choose the alternative with the lowest overall cost.
  - Investors or savers choose to invest in the markets or intermediaries that provide them with the risk-return-liquidity trade-off that best suits them.

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COMPETITION BETWEEN MARKETS AND INTERMEDIARIES

- Return:
  - How much an investor gets from owning an asset.
    - Can be positive or negative.
- Risk:
  - Variability of a return.
    - Risky asset.
    - Safe asset.
- Liquidity:
  - Speed with which an asset can be sold at something close to its real market value.

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COMPETITION BETWEEN MARKETS AND INTERMEDIARIES

- Investors care about risk, return, and liquidity as well as, generally, secondary considerations:
  - Investors will sometimes pay more for investments with fixed redemption dates to reduce uncertainty.
  - Investors will sometime pay more for instruments issued by environmentally or socially conscious companies.
- Borrowers compete with each other for funds by offering investors higher returns, less risk, or more liquid instruments.
  - They use whichever part of the financial system, markets or intermediaries, that offer them the best deal.

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COMPETITION BETWEEN MARKETS AND INTERMEDIARIES

Key Takeaways

- ✓ Investors primarily tradeoff between risk, return, and liquidity and to a lesser extent they also value the certainty of redemption terms.
- ✓ Borrowers want to obtain funds as cheaply as possible and on repayment terms as flexible as possible.

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REGULATION

Learning Objective

- Explain the functions of financial regulators.

What are the major goals of financial regulation?

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REGULATION

Reduce Asymmetric Information

- By encouraging transparency.

Protect Consumers

- By limiting the types of assets that various types of financial institutions can hold.
- By mandating minimum reserve and capitalization levels.

Promote Financial System Competition and Efficiency

- By ensuring entry and exit of firms.

Ensure Soundness

- By acting as a lender of last resort.
- Mandating deposit insurance.
- Limiting competition through restrictions on entry and interest rates.

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REGULATION

Key Takeaways

- ✓ Regulators attempt to maximize macroeconomic stability and transparency and minimize investor risk and loss.
- ✓ The policies they implement to do so, however, can be controversial and are not always effective.

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