MN10403

Revision Lecture:

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Structure

- Functions and features of financial markets
- Two-way causality between RE and FM
- Banking system
- Money markets
- Bond markets
- Equity markets
- Derivatives
- Regulation

Function of FS

- Efficient Transfer of funds from lenders to borrowers
- Borrowers and lenders can deal directly with each other
- Or can trade in organised markets
- Primary market (eg newly issued shares)
- Secondary market (after-issue trading) => promotes economic growth. How?
- Key players/institutions in the FMs (Banks, Investors, households, traders, financial intermediaries, credit-rating agencies, regulators : FSA)

Functions of FS (continued)

- Helping funds flow from lenders to borrowers.
- Other functions:
- Means of making payments.
- Insuring risk-averse individuals.
- Cheap and efficient way for investors to re-arrange their portfolios.

- Efficient borrowing and lending makes it easier for firms to raise finance and invest in economic growth.
- Efficient payment system encourages trade and exchange.
- Quantity of money in circulation => aggregate demand

- Increasing complexity in financial decision-making.
- Lots of new financial products (financial innovation).
- =>Increased **asymmetric information** and **moral hazard**.
- =>Increased number of scandals
- => Increase in Financial Regulation.

Financial Institutions as Intermediaries.

- Intermediation: Go-between between borrowers and lenders.
- Surplus sectors or units => deficit sectors or units
- Financial Intermediaries Create assets for savers/liabilities for borrowers more efficiently than if the parties had to deal with each other directly: eg mortgage on a house.

Creation of assets and liabilities

- Financial Intermediation =>
- More assets and liabilities than under direct lending alone.
- And lending and borrowing have become easier => lower transactions costs of lending and borrowing.
- Financial intermediaries are able to manage risk more efficiently than individuals.

Liquidity

- Speed and convenience with which an asset can be converted into money of a certain value.
- Under financial intermediation, lenders can recall their loan more quickly and with greater certainty.
- Liquidity: 3 dimensions: time, risk, and cost.

Maturity transformation

- Intermediaries must satisfy conflicting needs of borrowers and lenders.
- Maturity transformation.
- Accept deposits of a given maturity, transform them into loans of a much different maturity.
- Eg: building societies: accept deposits of a short maturity (liability): lend them to house buyers up to 25 years (asset).

Risk Transformation

- Reduction in risk achieved by diversification of lending and by screening of borrowers.
- Risk reduction.
- Default risk.
- Capital risk.
- Income risk.

Two-way causality

- Link between FS and RE
- Movements in RE => movements in FS
- Movements in FS =>movements in RE
- Units/sectors in the economy: households, firms, government
- Surplus units/defict units
- NI identity Y = C + I + G + (X – M)
- Quantity theory of money

Two-way causality (continued)

- FS => movements in RE
- FM ↑ => feel richer -=> boom in RE (and vice versa)
- => behavioural/psychological factors
- Target consumption

- Ideal world: FS channels funds efficently from lenders to borrowers.
- But: markets not perfect
- Frictions
- Taxes
- Transaction costs
- Moral hazard
- Asymmetric info
- => regulation debate: FSA

Banking System

- Banking system: maturity risk.
- Central bank (Bank of England): functions
- …. Supervisor of banking system
- …. Lender of last resort
- => confidence important in banking system
- => credit chains, credit cycles, contagion, bank runs
- Debate: should we allow one bank to fail (eg Northern Rock)?...

Bond mkt/stock mkt

- Bonds relatively safe/ equity relatively risky.
- Bond-holders get first fixed claim on the firm's cashflows: eg annual coupon payments (more or less guaranteed)
- Equity-holders: get capital gains and dividends: not guaranteed/ very volatile
- Moral Hazard/asymmetric information: low ability management, self-interested mgt, frauds….

- **Behaviour of Security Prices**
- DCF formulae (DCF for bonds: DVM plus CAPM for equity)
- Supply and demand diagrams.
- => based on efficient markets: FV = MV
- But behavioural/ psychological factors => FV not equalling MV:
- MV > FV: bubbles
- MV < FV: undervaluation/crashes

FSA

- Inefficient markets: MV < FV
- Insider trading
- Test of mkt cleanliness.

Derivatives

- Forwards, futures, options (call and put)
- Option diagrams: payoff profiles
- Use and abuse of derivatives
- => risky positions (eg straddle/upside down straddle)
- => safe postions (eg risk-free)
- => speculation or hedging
- Nick Leeson/Barings
- Other examples: see book

Debate over regulation

- Heavy-handed?
- Light-touch (FSA)
- Self-regulation….

- See book.