THE FINANCIAL MARKETS

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Financial Markets in the FS

- DIRECT finance »» an individual saver holds financial claims issued directly by an individual borrower.
- These direct finance arrangements take place through financial markets, markets in which investors lend their savings directly to borrowers.
- In INDIRECT finance through financial intermediaries, claims held by savers are claims against intermediaries that are backed by their portfolios of assets, which are claims on the borrowers.

Primary markets

- Primary markets are those in which newly issued claims are sold to initial buyers by the borrowers.
- Business use primary markets to raise funds for new ventures, and governments use them to finance budget deficits
- Borrowers can raise funds in a primary financial market in two ways:
  - 1. by borrowing or
  - 2. by selling shares.
- The first and most commonly used claim is DEBT, which requires the borrower to repay the amount borrowed, the principal, plus a rental fee, or interest.
- The other type of claim is EQUITY, which is an ownership claim to a share in the profits and assets of a firm.

Primary markets

- The length of the period of time before the debt instrument expires is its MATURITY, or term.
  - Short-term debt instruments have a maturity of less than one year.
  - Intermediate-term debt instruments have a maturity between 1 year and 10 years.
  - Long-term debt instruments have a maturity of 10 years or more.

- Lenders face the risk tat borrowers will default, or not be able to repay all or part of their obligations.

Primary markets

- Equity allows for variable payments from the borrower to the lender.
- An example is common stock, which entitles stockholders in a business to get their share of the firm´s profits after all expenses.
- Equity owners generally receive periodic payments from the firm, known as DIVIDENDS.
- Debt instruments actually account for more of the funds raised in the financial system.

Secondary markets

- Risk-sharing, liquidity, and information services are provided in SECONDARY markets.
- Markets in which claims that have already been isssued are sold by one investor to another.
- Most primary market transactions are sales of new debt or equity instruments to initial buyers and are conducted behind closed doors.
- The most widely reported SECONDARY MARKETS – the New York, American, and Tokyo Stock Exchanges.

Primary Markets

- Primary market: How to get money?
  - Private placement
  - Public placement

Private placement process

Private placement advantages

- High flexibility in amounts of financing
- Lower price
- Speed of transaction
- „smart“ investors
- Limited regulation (if any)
  - US – Regulation D from 1982
    - No general advertising
    - Sophisticated investors only
      - Capability to evaluate the risk
      - Enough resources to bear the risk
    - Memorandum is not supervised by SEC

Private placement disadvantages

- Difficult to locate suitable investors
- Difficult to syndicate
- Discount for risk

Public placement

- Initial Public Offering (IPO)
  - The first sale of stock by company to the public

Public placement advantages

- Greater acces to the capital
- Increased liquidity
- Market prestige
- Enhancement of public image
- Flexibility for emloyees ownership and participation
- Improved opportunities for M&A
- Increase in wealth for founders

Public placement disadvantages

- Dilution of founders´ control
- Pressure to meet expectations
- Change in management style
- Compliance with regulation & reporting
- Vulnerability to shifts in the stock markets
- High level of disclosure
- Related costs

Variations of underwriting

- Bought deal
- Preemptive rights offering
- Single setup price
- Auction process

Bought deal

- The whole issue is bought by single investor
- Introduced in Eurobond market in 1981
  - CSFB purchased 100 mil USD issue GM without any syndication
- Debt issues only

Preemptive rights offering

- New shares are issued to existing shareholders
- Preemptive right grants existing shareholder to buy some proportion of the new shares issued at a price below market value
- Preemptive right insures that existing shareholders may maintain their proportionate equity in the company

Single price underwriting

- Fixed price issues are issues in which the issuer is allowed to price the shares as he wishes.
- The basis for the price is explained in an offer document through qualitative and quantitative statements.

Auction process

- Competitive bidding underwrighting
  - A process whereby an underwriter submits a sealed bid to the issuer. The issuer awards the contract to the underwriter with the best price and contract terms.
- Single-price auction
- Multiple-price auction
- Bookbuilding vs. Single Price

Auction process

Bidder	Amount	Bid	Amount cum.
A	150	5,10%	150
B	110	5,20%	260
C	90	5,20%	350
D	100	5,30%	450
E	75	5,40%	525
F	25	5,40%	550
G	80	5,50%	630
H	70	5,60%	700
I	85	5,70%	785

Auction process – book building

- Technique used for marketing a public offer of equity shares of a company
- Range setup – floor & cap
- Bids collection & evaluation
- Allocation

Bid	Number of shares	Price per share	No. of shares cum.
1	20	40 USD	20
2	10	38 USD	30
3	20	37 USD	50
4	30	36 USD	80
5	20	35 USD	100
6	20	33 USD	120
7	20	30 USD	140

Single price vs book building

Features	Fixed Price process	Book Building process
Pricing	Price at which the securities are offered/allotted is known in advance to the investor.	Price at which securities will be offered/allotted is not known in advance to the investor. Only an indicative price range is known.
Demand	Demand for the securities offered is known only after the closure of the issue	Demand for the securities offered can be known everyday as the book is built.
Payment	Payment if made at the time of subscription wherein refund is given after allocation.	Payment only after allocation.

Green shoe option

- Clause contained in the underwriting agreement of an initial public offering (IPO), allows the underwriting syndicate/investment bank to buy up to an additional 15% of the shares at the offering price if public demand for the shares exceeds expectations and the stock trades above its offering price.
- The green shoe option provides extra incentive for the underwriters of a new stock offering. In addition, these investment banks, brokerages and other financing parties also often exercise the green shoe option to cover some of the short position they may have created in an effort to maintain a stable market after a new stock begins to trade, as well as to meet aftermarket demand.
- The Green Shoe Company was the first issuer to allow the over-allotment option to its underwriters, hence the name.

Secondary Markets

- Smoothly functioning secondary markets make it easier for investors to reduce their exposure to risk by holding a diversified portfolio of stocks, bonds, and other assets.
- Secondary markets also promote liquidity for stocks, bonds, foreign exchange, and other financial instruments so that it is easier for investors to sell the instruments for cash.
- This liquidity makes investors more willing to hold financial instruments, thereby making it easier for the issuing firm or government agency to sell the securities in the first place.
- Secondary markets convey information to both savers and borrowers by determinig the price of financial instruments.

Secondary Markets

- Secondary markets are also important for global foreign-exchange transactions.
- Regardless of the type of instrument being traded, the buyer of the instrument in a secondary market pays money to the seller.
- The initial seller of the instrument does NOT receive the proceeds.
- The initial issuer receives only the proceeds from the sale of the instrument in the primary market.

Secondary markets

- Secondary markets can be categorized by:
  - 1) what maturity level characterizes the claims being traded,
  - 2) how trading takes place, and
  - 3) when settlement takes place.

- 1) Maturity: money and capital markets
  - a) In CAPITAL markets are traded debt instruments that have a maturity of greater than one year and equities, which have no fixed maturity.
  - b) In MONEY markets are traded short term instruments, with a maturity of less than one year.

Maturity: Money and Capital Markets

- 3 differences between money market and capital market instruments.
- 1. Short- term instruments have relatively small increases or decreases in price, so they are less risky as investments than long-term instruments are.
- As a result, financial institutions and corporations typically invest short-term surplus funds in money markets.
- Some financial institutions, such as pension funds and insurance companies, are willing to hold assets for a long time and risk price fluctuations in capital markets.

Maturity: Money and Capital Markets

- 2. Money market instruments are generally more liquid than capital market instruments because their trading volume is greater and the cost of buying and selling is low.
- Thus households and businesses can invest their funds for a short period of time relatively cheaply.
- 3. Information cost are lower for money market instruments because the borrowers are well known and the length of time for which funds are loaned is relatively short.

Money Market

CZK	date and time	bid	offer	change
ON	09/22/2006 10:45	1.3000	1.4000	-3.57%
TN	09/22/2006 10:45	1.4000	1.5000	-27.50%
1 week	09/22/2006 12:25	1.9500	2.0700	3.08%
1 week	09/22/2006 11:19	2.1300	2.2000	8.25%
1 month	09/22/2006 17:23	2.2400	2.3200	-3.80%
2 month	09/22/2006 17:19	2.4400	2.4800	3.80%
3 month	09/22/2006 17:52	2.5300	2.5700	1.59%
6 month	09/22/2006 17:51	2.7100	2.7900	0.73%
9 month	09/22/2006 17:50	2.9100	2.9900	2.08%
1 year	09/22/2006 17:07	3.0700	3.1100	3.69%

Trading place

- a) **AUCTION** markets, in which prices are set by competitive bidding by a large number of traders acting on behalf of individual buyers or sellers.
- The most common auction markets are EXCHANGES. For example: the New York and American Stock Exchanges, the Tokyo Stock Exchange, the London Stock Exchange, etc.
- b) **OVER-THE-COUNTER (OTC)** markets, in which there is no centralized place for exchanges.
- Over-the-counter dealers buy and sell stocks and bonds through computerized trading to anyone who is willing to accept their posted prices.
- Close electronic contact keeps the over-the-counter market competitive.

Trading place

- The equities of the largest corporations are traded on exchanges.
- The shares of smaller, less well-known firms are generally traded in over-the counter markets.

Settlement: Cash and Derivatives Markets

- a) **CASH markets** are those markets in which actual claims are bought and sold with immediate settlement: The buyer pays money to the seller in exchange for the asset.
- b) In **DERIVATIVE markets** trades are made now, but settlement is made at a later date.
- The reason is that households and businesses use derivative markets to reduce their exposure to the risk of price fluctuations in cash markets.

Settlement: Cash and Derivatives Markets

- Derivative claims, the value of which is determined by underlying assets, include financial futures and options.
- Financial **FUTURES** require settlement of a purchase of a financial instrument at a specified future date, with the price determined at the outset.
- **OPTIONS** on financial contracts confer on the trader the right (or option) to buy or sell a particular asset within a specified time at a specified price.

Financial Innovation

- Changes in cost of providing risk-sharing, liquidity, or information services or changes in demand for these services encourage financial markets and intermediaries to alter their operations and to offer new types of financial assets and liabilities.
- These improvements in the financial system are called financial innovations.

Changes in Financial Integration

- One measure of the system's efficiency is its degree of financial integration, or the way in which financial markets are tied together geographically.
- The increasing ease of communicating information has enabled financial markets to become much more integrated.
- Globalization
- A major development during recent decades has been the global integration of financial markets.
- The globalization of financial markets improves the ability of the FS to channel savers´ funds to the highest-value borrowers, wherever they may be.

Globalization

- 1980s and 1990s is a time when the greatest number of boundaries separating national financial markets in the US, Europe, Japan, and emerging economies dissolved.
- These changes mean that the money in your savings account might go to help finance a new factory in Germany, etc.
- Three trends toward globalization are of interest.
  - 1. Business is global.
  - 2. Financial markets are global.
  - 3. Lending is global.

Globalization

- The globalization of financial markets has two effects:
- 1) The easy flow of capital across national boundaries helps countries with productive opportunities to grow, even if their current resources are insufficient.
- 2) Increasing financial integration around the world reduces the cost of allocating savers´ funds to the highest-valued uses, wherever they may be.
- That is what the financial system is supposed to do.