Chapter 6

Financial Markets, Institutions and Securities

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Chapter Outline

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Financial markets allow for the exchange of funds between savers and users of these funds, which creates economic wealth.

The benefits of financial markets to a country include:

- Consistent economic growth
- Industrialization
- Increasing living standards
- Higher incomes
- etc.

When a transaction occurs between a saver and a user of funds, it must be beneficial for both parties.

Users of funds provide securities in exchange of savers’ cash. A security indicates the compensation a saver will receive in return for providing funds. Such compensation can be:

- a rate of return on the funds;
- a promise to repay a specific amount at some point in time;
- a right of ownership;
- the right to purchase another security at a pre-specified price.
Financial intermediaries facilitate the exchange of funds between savers and users, thus allowing financial markets to function efficiently.

Banks, insurance companies and investment dealers are examples of financial intermediaries.

Participants in financial markets are individuals, governments and businesses. Individuals have historically been net suppliers of funds whereas governments and businesses have historically been net demanders of funds.

At the international level, some countries are net demanders of funds while others are net suppliers of funds.
There are two distinct financial markets: The money market and the capital market.

Securities that mature within one year (debt) are traded in the money market. These usually involve large sums of money.

Securities that mature in more than one year (long-term debt and stocks) are traded in the capital market.

Financial markets can also be classified by the nature of transactions.

Primary markets’ transactions involve newly created securities.

Secondary markets, on the other hand, allow for the trade of previously created securities.
Flow of Funds in Financial Markets

See Figure 6.2

The Financial Markets in Operations

Suppose Richard Spear wants to buy a $25,000 car.

If Richard does not have the money right now, he could save it and buy the car once he has enough money or he could borrow the funds.

If he borrows the funds through a financial institution, he will issue a security, a car loan, in exchange of the cash.

Without financial intermediaries, obtaining the funds would be a lot more difficult.

If Richard saves until he has enough money to buy the car, the process is the reverse.
Financial Intermediaries

There are six principal financial intermediaries in Canada:

- Deposit-taking, loan-making institutions;
- Investment dealers;
- Mutual funds;
- Pension funds;
- Life insurance companies;
- The Bank of Canada.

Trust and Financial Markets

A key concept in financial markets is “trust”.

When depositing money at the bank, individuals assume they will be able to access this money when needed.

Similarly, investors must have some confidence that the information disclosed by public companies is true in order to buy their securities.

Many aspects of financial transactions involve “conventions” arising from trust in the system (paper money, for example).
Money Market Instruments

Treasury Bills:

- Sold by the Bank of Canada through a competitive bidding process.
- Sold to the distributors of the Government of Canada securities.
- T-bills are sold on a discount basis at both the auction and subsequent trading on secondary markets.

\[ P = \frac{V}{1 + i \times \frac{n}{365}}. \]
Treasury Bills:
The price of a T-bill with $V = 1,000$, $i = 8.76\%$ and 91 days to maturity is

\[ P = \frac{1,000}{1 + 0.0876 \times \frac{n}{365}} = 980.93 \]

The auction of T-bills has two purposes:

- raise funds to pay maturing T-bills;
- Extra funds are used to finance government operations.

From March 1980 to February 1996, the weekly T-bill auction (not weekly anymore) was used to determine the bank rate.

The bank now sets the overnight rate, the average rate the Bank wants financial institutions to use for one-day loans among themselves.
The overnight rate is the Bank’s main tool to conduct monetary policy.

The overnight rate is also the foundation for other interest rates in the economy.

The Bank of Canada operates the system to make sure trading in the overnight market stays within its operating band, which is one-half of a percentage point wide.

If the overnight rate is 4.75%, then the operating band is 4.25% to 4.75% and thus the “target” overnight rate is 4.5%.

The Bank of Canada lends money at the overnight rate and pays interest at 0.5% below the rate (bottom of the band).
Other Short-Term Instruments

- Short-term governments bonds
- Commercial paper
- Finance company paper
- Banker’s acceptance
- Day loans
- Eurocurrency market

Capital Market Securities: Long-Term Debt

**Bond**: Long-term debt security that has specific assets pledged as collateral.

**Debenture**: Unsecured long-term debt. Backed by the general earnings potential of the corporation.

**Long-Term Debt**: Contractual liability between a borrower and a lender.
Types of Bonds and Debentures

- Mortgage bonds
- Debentures, subordinated debentures
- Income bonds
- Zero-coupon bonds
- Retractable bonds
- Convertible bonds

Trust Indenture

- Financial information
- Collateral
- Restrictive covenants
- Call feature
- Sinking-fund requirements
bond ratings (DBRS)

AAA: Highest credit quality
AA: Superior credit quality
A: Satisfactory credit quality
BBB: Adequate credit quality
BB: Speculative
B: Highly speculative

setting coupon rates

floor rate: Yield provided on federal government debt.

risk premium: Additional coupon investors will demand based on the risk of the issuer (bond rating) and of the debt issue (specifics of the issue).
International Bond Issue

Companies and governments can use Eurobonds to borrow internationally.

A Eurobond is issued by an international borrower in a currency other than that of the country in which it is sold.

For example, a Canadian company could sell a Eurobond denominated in Japanese yen in Germany.

A foreign bond is a bond issued in a country’s financial market, in that country’s currency, by a foreign borrower.

Common and Preferred Shares

**Limited Liability:** Investors cannot lose more than what they invested in the company.

**Privately Owned Company:** All common shares are owned by a single individual.

**Closely Owned Company:** All common shares are owned by a small group of investors.

**Publicly Owned Company:** Common shares are owned by a broad group of unrelated individuals or institutional investors.
Preemptive Rights: Allows common shareholders to maintain their proportionate ownership in the corporation when new shares are issued.

Dilution of Ownership: Occurs when a new share issue results in each present shareholder having a claim on a smaller part of the firm’s earnings than previously.

Rights: Financial instruments that permit shareholders to purchase additional shares at a price below market price, in direct proportion to their number of owned shares.