Financial markets class assignment

Business

The paper discusses the consequences of information symmetry in the market for used cars (lemons). (“ lemons”) George Croaker 3 Financial markets class PPTP By near 2. 3. 4. 4 5. 6. 7. 8. Stocks are not the most important sources of external financing for businesses Issuing marketable debt and equity securities is not the primary way in which businesses finance their operations Indirect finance is many times more important than direct finance. Financial intermediaries particularly banks, are the most important intermediaries, banks source of external funds used to finance businesses.

The financial system is among the most heavily regulated sectors of the economy Only large, well-established corporations have easy access to securities markets to finance their activities Collateral I C II t I is a prevalent feature of debt contracts for both lilt f d bit TTFN the households and businesses. Debt contracts are extremely complicated legal documents that place substantial restrictive covenants on borrowers. B t it I tit b Sources of External Funds for Nonofficial Businesses Source: Andrea Hackett and Reinhardt H.

Schmidt, “ Financing Patterns: Measurement Concepts and Empirical Results,” Johann Wolfgang Goethe University Working Paper No. 125, January 2004. The data are from 1970-2000 and are gross flows as percentage Goethe-University 1970 2000 of the total, not including trade and other credit data, which are not available. 5 “ When you do business with people you would be better off avoiding. This is one of two main sorts of market f IL did HTH I Ft TFH k t failure often associated with insurance. The other is moral hazard.

Adverse selection can be a problem when there is asymmetric information between the seller of insurance and the buyer; in particular, insurance will often not be profitable when buyers have better information about their risk of claiming than does the seller. Ideally, insurance premiums should be set according to the I k f t the risk of a randomly selected person in the insured slice of d I Ltd I the I the population (55-year-old male smokers, say). In practice, this means the average risk of that group. Roof 6 If there is adverse selection in a market, then this market is not functioning f it I properly, because the “ bad” product or services are I b the “ b d” preferred (selected) in this market. The term adverse selection was originally used in insurance. Insurance One is more likely to buy insurance (and to demand high coverage) if he thinks he is at high risk of loss. Joss The insurer might not know the true risk of the person demanding insurance. Accepting to insure such person would be “ adverse. On the other hand, there is high demand for insurance by high risk people. 7 When h I d Who there is adverse selection, people who know they have a higher risk of claiming than the average of the group will buy the insurance, whereas those who have a below-average risk may decide it is too expensive to be worth buying. In this case, premiums set according to the average risk will not be sufficient to cover the claims that eventually arise, because among the p p who have y people bought the policy more will have above-average risk than beleaguered risk.

Putting up the premium will not solve this problem, for as the premium rises the insurance policy will become unattractive to more of the people who know they have a lower risk of claiming. One way to reduce adverse selection is to make the purchase of insurance compulsory, so that those for whom insurance priced for compulsory average risk is unattractive are not able to opt out. ” http://www. Economist. Mom/economics-a-to-z 8 d In the context of insurance, “ Moral hazard means that people with insurance may sake greater risks than they would do without it because they know they are protected, so the insurer may get more claims than it bargained for. ” http://www. Economist. Com/economics-a-to-z/m This applies to deposit insurance, which covers bank deposits, and also to institutions that are too big to fail: these might take excessive risk because they know that they will not be allowed to fail.

Moral hazard might be a consequence of information asymmetry: those taking excessive risk would not be offered insurance if the insurance knew they would take excessive risks. 9 Lender of last resort Lender f I L d of last resort manically troubled banks need cash and nobody else will lend to y them, a central bank may do so, perhaps with strings attached, or even by taking control of the troubled bank, closing it or finding it a new owner owner.

This role of the central bank makes credit creation easier by increasing confidence in the banking system and minimizing the risk off b k run by reassuring depositors that their money I b id it the t the I the I k f bank is safe. However, it also creates a potential MORAL HAZARD: that banks , will lend more recklessly because they know they will be bailed out if things go wrong. ” http://www. Economist. Com/economics a to z/l http://www economist com/economics-a-to-z/l 10 Asymmetric information in finance There The are many examples of financial markets that have a f FL problem of asymmetric information.

When a company sells shares to the public in an PIP, insiders PIP clearly know more about the company than the potential buyers of the shares. They might use “ aggressive accounting” (or fraudulent (f d I accounting) to paint a good picture. A company’s management, who has been hired by the owners of the company to run the business, might choose to maximize business his wealth rather than the owner’s wealth. He clearly knows more about the company (which he is managing) than its owners. HTH is a principal-agent problem.

This I In a dealer’s market, buyers and sellers transact with dealers, not among themselves (buyers with sellers). Sellers) 11 Asymmetric info. In debt markets info Borrowers might have incentives to take on projects that are riskier than the lenders would like. Consider the case of bankruptcy either for a company or for an bankruptcy, individual. Suppose there is collateral. Does this remove the incentive to up take on excessively risky projects? Do you think that Greece will be able to return to the international debt market any time soon? 2 Moral Hazard: Solutions Net N worth and collateral h d II Incentive compatible Monitoring d E f M it I and Enforcement of Restrictive Covenants deficit Discourage undesirable behavior Encourage desirable behavior Keep collateral valuable Provide information Financial Intermediation Facts 3 & 4 13 Asymmetric Information: Problems and Solutions Corporate governance The Serbians-Solely Act of 2002 (P blip A o I Oaf (Public Accounting R I Return and Investor Protection Act) increased supervisory oversight to monitor and prevent conflicts of interest

Beefed up criminal charges for white-collar crime and obstruction of official investigations Required the R I d the CEO and SCOFF t certify that financial statements and d to tiff the t FL disclosures are accurate Required independent members of the audit committee and the Board of Directors Made it illegal for a registered public accounting firm to provide any annuity service to a client contemporaneously with an impermissible audit Established a Public Company Accounting Oversight Board Increased the SEC's budget 15 Global Legal Settlement of 2002 The GIG The Global Legal Settlement reached in 2002 on charges of h " tainted research"

Required investment banks to sever the link between research and securities underwriting (Chinese wall) Banned the practice of " spinning" (quickly selling the products one is underwriting) Imposed $1. 4 billion in fines on accused investment banks Required investment banks to make their analysts' recommendations blip public Over a 5-year period, investment banks were required to contract with at least 3 independent research firms that would provide research to their b k the I brokerage customers. 6 The scandal at Olympus http://www. Ft. Com/indents/Olympus HTH // d the/ I Olympus is litmus test on governance Financial Times, February 22 2012 Times The accounting fraud at Olympus has shattered public faith in the Japanese business establishment and prompted anxious calls for better corporate governance in the country. But even as the Japanese authorities last week arrested seven people allegedly involved in the cover-up of more than cover up Yellow ($1. Bin) in losses, one key group has been conspicuously silent – Japan's large, institutional investors, who are among the biggest shareholders in the Japanese camera and medical equipment maker. Http://www. Ft. Com/SMS/s/O/cheese Dodd 1 eel off http://www Ft com/SMS/s/ 0/cheese-Dodd-11 -off biofeedback. HTML#Aziza powwow's 17

Adverse Selection: Solutions Private P I t production and sale of information d I if Free-rider problem Government regulation to increase information Not always works to solve the adverse selection problem, explains Fact 5.

Financial intermediation Explains facts 3, 4, & 6. C II t I and net worth the Explains fact 7. 18 Financial intermediaries Even Google, when it did its PIP in 2004, hired some very expensive investment banks (“ underwriters”). Why? Couldn’t G C old ‘ t Google have sold its shares directly to buyers? La old it h did TTL tab Why are financial intermediaries such as investment banks, onslaught, consultants private bankers needed? Can you think of other markets in which intermediaries are found between buyers and sellers?

Financial intermediaries have evolved to reduce transaction costs, thanks to their: Economies of scale Expertise (particular, legal expertise) (in p 19 Brokers and Dealers Broker: An intermediary who brings buyers and sellers together and executes their orders, generally charging a commission for this service. Service Securities dealers buy and sell stock for themselves. Their role is to provide liquidity to the market in which they operate, I. E. Operate I e o “ make the market. ” Dealers are market makers. Examples: NYSE specialists, Nasdaq dealers, derivatives market makers.

In contrast to a dealer, a broker does not own or take a position in I securities. Brokers act as agents, dealers as principals. Tit BC t ODL “ Broker-Dealers” do both. Some traders (e. G. Members of NYSE or a De vat eves exchange) can also execute customers orders derivatives sec a GE) ca a so e acute custom sees o De s (as brokers). B o e s). 21 ETC markets Over-the-counter (ETC) markets are private networks of dealers (market makers) and institutional traders (hedge funds, pensions funds etc. Linked via telephone and the internet. Ands, etc) internet Transactions conducted by phone are usually taped. Transactions are customized (bespoke), rather than (“ bespoke”) standardized, and are in large denominations. Examples: the pink sheet stock market (unlisted shares), the p currency market, the market for interest rate swaps, CDC make. Www. Alba. Org. UK Different types of markets At A ENZYME(did (a derivatives exchange) buyers and sellers meet)b directly on the floor to trade, without the interposition of (dealers (market makers). This is an order driven market (and an open outcry market).