Chapter 2

Financial Markets and Institutions

***The Instructor’s Manual is divided into two parts. The first is an overview of the chapter, including a description of the material covered and a perspective on how the chapter content relates to the balance of the textbook. The second part reviews the learning objectives of the chapter and includes a list of challenges encountered by students when learning the material. Where appropriate, pedagogical ideas and tips are provided to improve student learning.***

# OVERVIEW

Chapter 2 covers the financial system, which is a significant part of the operating environment of any business, especially a large, public corporation. The primary focus of this chapter is on how financial markets and institutions supply financing for investments made by corporations. Financial markets offer a constant "performance evaluation" of company performance in the form of securities prices. The concept of opportunity cost of capital is expanded and presented as a method by which financial markets establish expected returns.

The material in this chapter can be very exciting for some students as they come to this course expecting to learn how to make money in the stock market. It is important to emphasize the reason for studying this material is to understand how financial markets and institutions supply financing for investment by corporations. Students can be enticed with this information to go on and take an investment course, but the primary focus here is on the decisions of the corporate financial manager.

# REVIEW OF LEARNING OBJECTIVES (with teaching tips and notes)

The **first learning objective** of this chapter is an understanding of how financial markets and institutions channel savings to corporate investment. Households and foreign investors provide most of the savings for corporate financing; financial markets and institutions provide the process and contracts to channel funds from savers to corporations for real investment. Figures 2.1 and 2.2 are an excellent graphics for facilitating this discussion.

**Teaching Note: The Stock Market –** The above warning notwithstanding, students may benefit from creating a shadow investment portfolio and following it throughout the course. This project can be run on paper or with one of the many stock simulation software programs available to instructors. After discussion of the material in later chapters, students can investigate the PE and Market-to-Book ratios of their portfolio companies, calculate individual betas and a portfolio beta, and calculate a weighted average cost of capital for each firm they are following. It may also be interesting, when discussing the efficient market hypothesis, to compare student results to a randomly selected portfolio.

The **second learning objective** of this chapter is an understanding of the basic structure of banks, insurance companies, mutual funds, and pension funds. The financial intermediaries described here include commercial banks, finance companies, life and casualty insurance companies, credit unions, and savings and loan associations. Mutual funds and pension funds are also explained.

**Teaching Note: Capital Market Efficiency -** Finance in Practice Box *Micro Loans, Solid Returns,* offers insight into how interest rates are set. A beneficial exercise may incorporate students offering explanations as to the differences between the microfinance loan market and more traditional financial markets. Clearly, the size, liquidity and risk associated with this market are good topics students may quickly identify. It is interesting to see what other differences students see.

The **third learning objective** of this chapter is an explanation of the functions of financial markets and institutions. The five functions covered are transporting cash across time, risk transfer and diversification, liquidity, a payment mechanism, and information. The final function, information, is important to discuss as the pricing of securities imparts required rate of return information for new corporate investments (cost of capital) on a continuous basis.

**Teaching Note: Capital Market Efficiency -** Finance in Practice Box *Prediction Markets,* provides an interesting example on how a market works. This example can prepare the students for the later more in-depth discussion of the efficient market hypothesis. The Iowa Electronic Markets is a good market to discuss if you are teaching during an election year.

The **fourth learning objective** of this chapter is an understanding of the main events behind the financial crisis of 2007–2009. The authors describe how a huge expansion in subprime mortgage lending led to a collapse of the banking system which the government was forced to bailout. The importance of the Federal Reserve to financial markets, the role of credit rating agencies, and agency problems at banks are all discussed here.

**Teaching Note: Ethical Issues –** Section 2.4 includes a discussion of how banks expanded the supply of sub-prime mortgages and tempted many would-be homeowners with teaser introductory interest rates. The authors describe the agency problems surrounding bankers that may been guilty of promoting these financial products.