ICMA
International Capital Market Association

Section One
Overview of the Financial Markets

1.1 Background to the Capital Markets

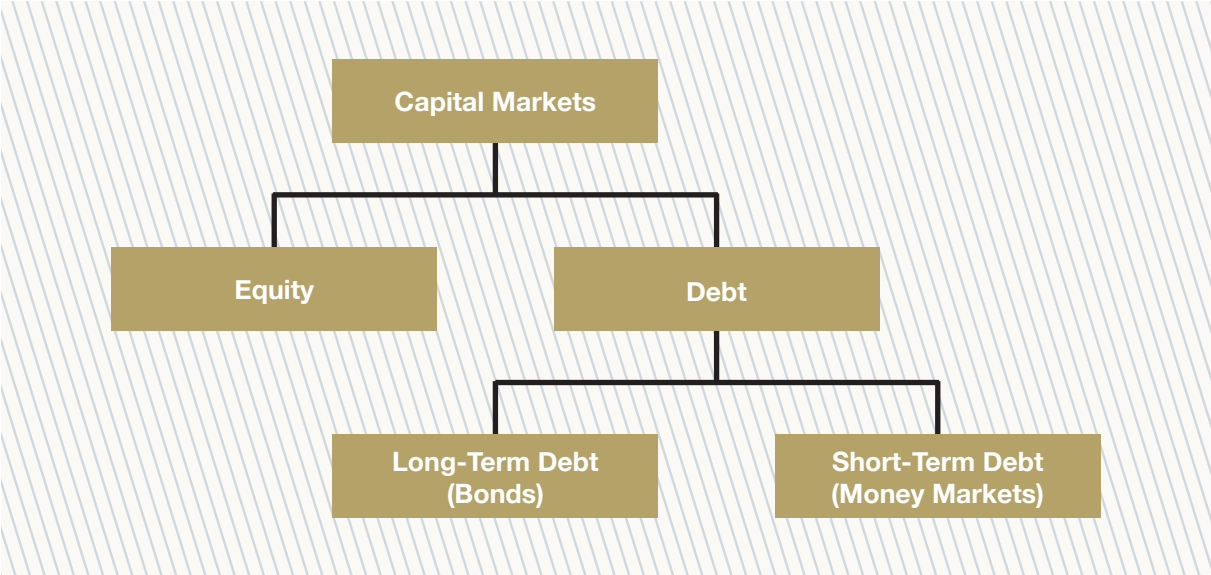
1.2 Key Players

1.3 Trade Flow

Introduction

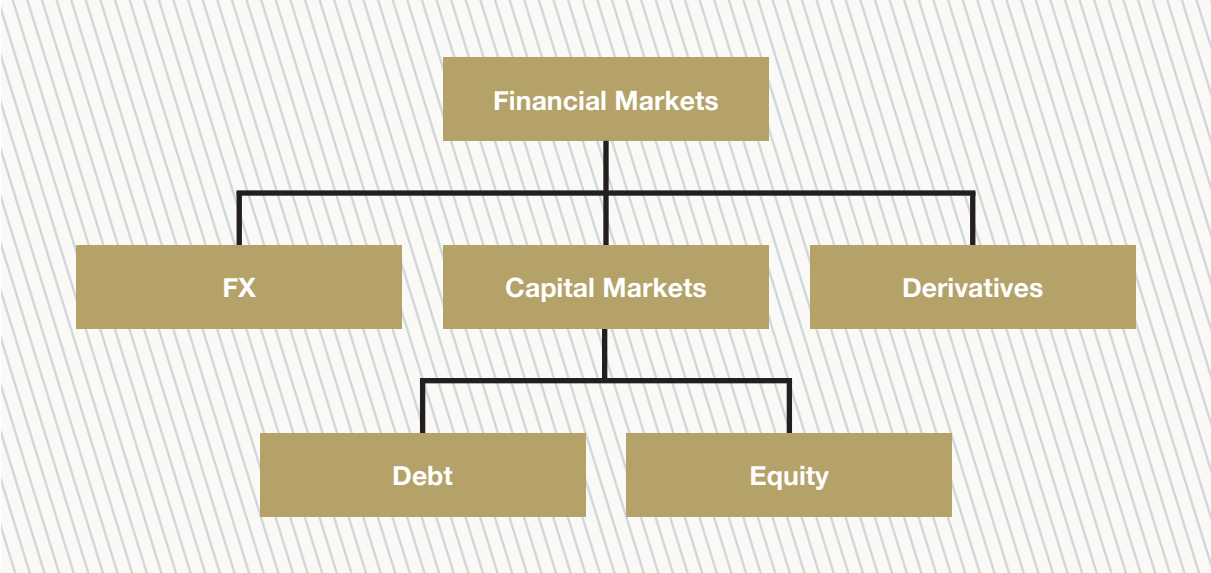
To begin looking at the financial markets it makes sense to first make it clear how the different parts fit together. At their heart we have the *capital markets* which are the markets where we raise and place wholesale funds. Capital markets are so-called because the main purpose of raising funds in this way is to raise long-term capital, funds needed for more than a year. We will talk about short-term debt though this is more often used for day-to-day financing, as there are some products that we would consider do form part of our financial markets, and we will discuss the crossover between financial markets and traditional bank financing.

The diagram below shows the parts of the market that make up the capital markets:



As we will see, money can be raised by either issuing debt or equity and the debt can be sub-divided into short-term or long-term, but more of this later.

In this next diagram we substitute Financial Markets for Capital Markets and see how the other market areas fit into the diagram:



In the centre of the diagram we still see capital markets but this time we have also added FX and Derivatives. These markets are not part of capital markets, they do not raise funds, but they are very important ancillary markets, providing the means to change and control the exposures that arise from our capital markets activity. We will be looking at each of these in turn.

We will also introduce the key players in the market and come to an understanding of the motivations for their various activities so that we can build up a sense of how these markets work, and indeed thrive.

As you work through the sessions you will see that we have included several questions for you to stop and test yourself. You will find the answers to these questions at the end of the session so that you can check how well you did.

There is also a glossary reminding you of some of the key terminology we have introduced in this part of the material, just giving a quick reminder of what these expressions mean.

Section One

1.1 Background to the Capital Markets

Key Content:

- Introduction to capital markets
- Concept of disintermediation
- Explain how banking and financial markets co-exist

Financial markets are all about money. At their heart is the idea of moving money from those that have to those that want, but it is the way in which this happens that makes financial markets so complex and fascinating. Financial markets have been around for many centuries and we can trace the development of our key products from these early times, but it is really only in the last few decades that we have seen the markets evolve to the level of sophistication that we encounter today.

As we go through this course we are going to see a range of products that the market has created to fulfil the various needs of participants and we will start to build our understanding of why the markets have developed in this way. To begin, though, we need to get our heads around the basic purpose of financial markets which, as we have said, is moving money from those who have to those who want. We also need to look at how this fits in with traditional banking, a related but different way of achieving the same aim.

Banking and Financial Markets

Traditionally if you were looking to raise money you would go to an institution whose business was to facilitate the movement of funds in an economy: in other words, a bank. These institutions were set up with the purpose of moving the commodity of money, taking from those who have and giving to those who want, to enable liquidity in the economy. The bank stands as a middleman in the transaction and therefore takes a fee, often expressed as the difference between the rate they charged for borrowing money and the rate they paid to those who gave them money. Their success hinges on having enough customers on both sides of this fence

A customer is looking to raise funds so they go to the bank from whom they want to borrow the money... which comes at a cost

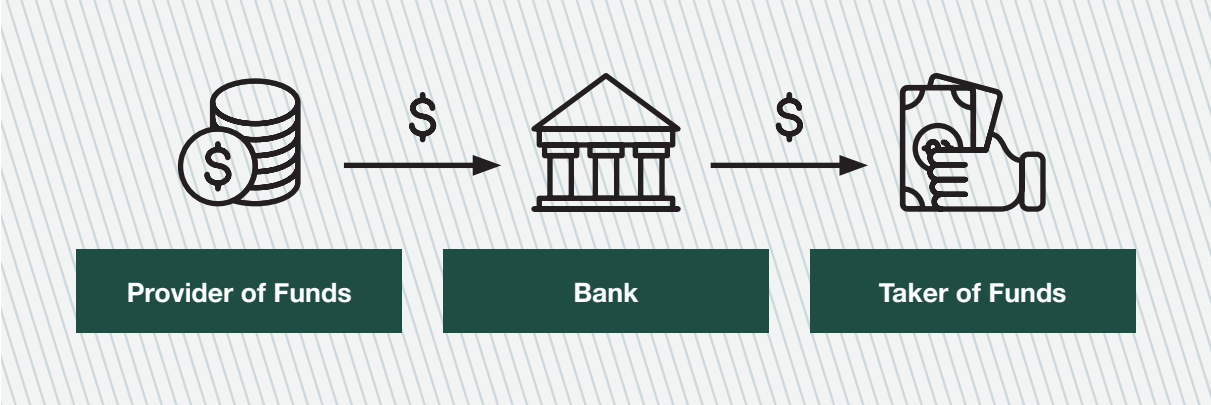
In this deal the customer will borrow money from the bank and will pay the cost, expressed as an *interest rate to the bank*. In this way we can see the bank as a provider of liquidity, facilitating that movement of funds in the economy. This deal, of course, is dependent on the bank having the funds available in the first place.

Earlier we described the money in this deal, the funds being lent, as the "commodity" of money and this is just how the bank must consider it. In other words, like any trade transaction, in order to be able to sell you must be able to buy (or have) the commodity. Therefore, in this instance, to be able to provide funds you need to be able to find them. In the ideal world this will come from another customer...

Another customer has excess funds – The bank is seen as a safe place for the funds, they are the safekeepers so the customer goes to place their money with the bank – and hopes to receive a return

So now we have the bank in the perfect position of having one customer providing the funds that another customer wants to borrow.

The provider of funds is hoping to make a return on their money, again an interest rate that they will receive. This will come from the bank, who will pay the lender a part of the interest rate that they receive from the taker of funds, the borrower. So the borrower pays interest, let's say ten percent (10%) to the bank for borrowing the funds; the bank then pays the investor five percent (5%) interest on the money they have placed and the bank's profit comes from the five percent (5%) they have retained on the deal. If the bank manages to find these two matching customers we have a perfect intermediated model of moving funds:



Risks in this Model

Of course when we say we have a perfect model of moving funds this does depend on both sides of the trade matching in terms of the size of funds and amount of time for which they are available and required, and very often we will not find this perfect match. This is part of what makes this a risky model.

Typically the bank will not be able to match up one customer with another but instead will look to try and balance books of different providers and takers of funds, matching up as best they can, but often being confronted with significant mismatches in maturity that leadis to an ongoing need to fund existing loans. This leads to ***Liquidity Risk*** – the risk that they may not be able to find the funds that they need.

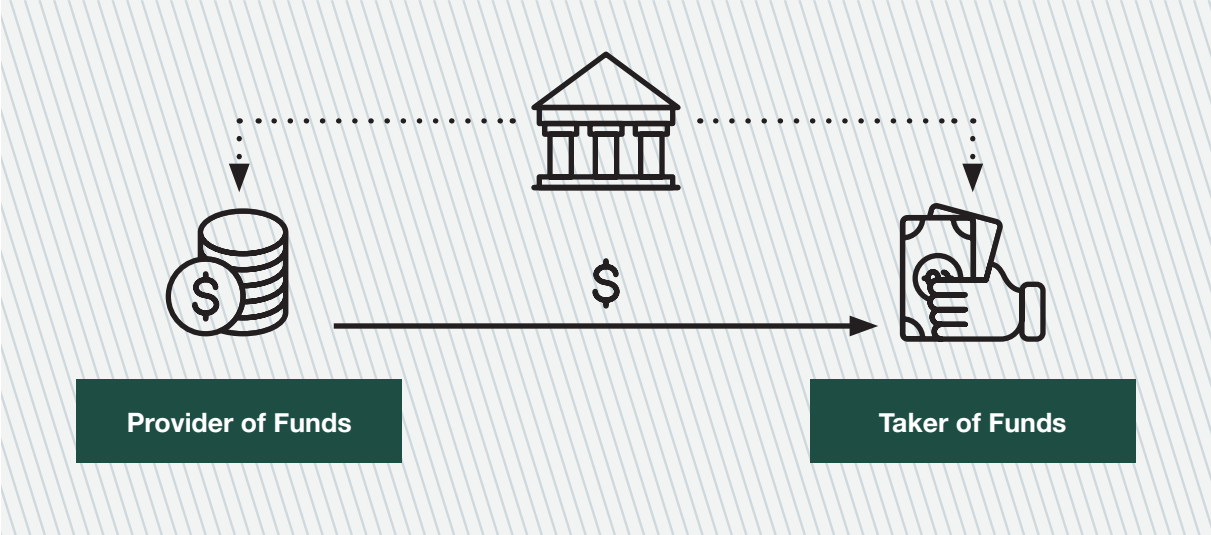
Liquidity risk also arises if the providers of funds change their mind about leaving their cash with the bank. It could be that the customer said they were placing funds for one month but then decide they want their money back after one week; the funds are theirs so if they require them to be returned the bank will have to do this, and so then they will need to go out and find replacement funds.

Another significant risk we can see in this model is ***Credit Risk***. The way we have looked at this movement of funds is as two separate transactions that we have joined together. The lender lent to the bank, the borrower borrowed from the bank. If the borrower, for some reason, cannot repay the money then they will default to the bank. The bank carries this credit risk. The funds may have come from the lender but the borrowing contract is with the bank.

Of course this default could mean that the bank cannot repay the lender, which shows that the lender has credit risk to the bank. Importantly, though, whilst it may be the borrower's default that in turn caused the bank to default the lender has no recourse beyond the bank. Their contract is with the bank – both transactions are separate from one another.

Disintermediation

As a contrast to this model of classic borrowing and lending what we will often see in financial markets is a different model known as disintermediation. In this case we still have the 3 players, the borrower, lender and bank, but their relationships are significantly altered. The basic premise of disintermediated borrowing and lending is that that bank, the intermediary, becomes a facilitator, finding and putting together the two sides, rather than standing in the middle of the flow. So, we end up with a cashflow that looks like this:



As we can see the bank is still in the picture but with a different role. If they are able to find the two matching sides of the trade the funds then flow directly, or as close to directly as possible, between lender and borrower. This means that they both take on direct counterparty risk, rather than the bank acting as an additional counterparty in the deal. This is where we can really start to see the difference between traditional banking and financial markets as we start to look at how these funds will flow to create the most efficient model for all concerned.

Primary and Secondary Markets

The whole idea behind making this cashflow efficient is to commoditize the money or, in other words, to make instruments that can be bought and sold by the lender and the borrower. These instruments are known as securities. So far we have been looking at the idea of borrowing and lending and so the way that we can commoditize this is to take the loan and essentially package it, creating a debt security.

To make the buying and selling of our security even more efficient we like to use structures that mean we can subdivide: in other words the loan can be broken into smaller parts meaning that lots of different lenders can contribute to the raising of one wholesale amount of money. In fact, this is one of the main reasons that this disintermediated model is only used to raise *wholesale funds*. If the customer is looking to borrow a small amount of money then there is no benefit to this structure and so the borrower will use the traditional banking model we have already looked at. We typically call these small size deals *retail* deals. However, if the customer is looking to raise a larger sum, and for us a wholesale sum would typically be in the many millions and upwards, then the choices are greater.

The borrower becomes the *issuer* of this packaged loan, the debt securities, that will then be sold to a number of lenders, also known as investors. To entice the investors the issuer will make a series of promises the most notable being the promise to make interest payments to whoever holds the debt securities on specific contractual dates, and the promise to repay the loan, again to whoever owns the debt securities on a known maturity date. This is all decided in advance and it is the bank who will take on the task of coordinating and presenting this security to the market.

Once the details have been finalised, the bank can then go out and offer this security to a whole range of investors, again using their knowledge of who might be likely to be willing to lend to this issuer. This means that ultimately the issuer has the great advantage of increasing the number of potential investors, and if we have a large pool of investors we should be able to reduce the borrowing rate. Whilst the issuer is raising funds each individual investor does not need to have wholesale funds to buy a part of this deal. The securities can potentially be offered to both retail and wholesale investors alike, so disintermediation is a wholesale market for raising funds but a wholesale and retail market for placing funds.

Another thing to note is that borrowing is not the only way of raising money. It could be that the firm that is looking to raise funds would prefer not to borrow money but would rather look for investors who would be willing to buy part of the business. In the same way as before the bank could create a security, this time an equity deal that allows investors to buy a share in the company. Again the method would allow issuers to raise wholesale funds from both retail and wholesale investors. So, raising funds in these ways, either by debt or by equity, becomes the *capital markets*, which, as we have said, are at the heart of the financial markets.

The creation and initial sale of these securities is what we call the *primary market*. The bank will be paid by the issuer for creating the deals, which include all the legal work that is required to ensure that the investors know just what they are buying, and also for their efforts in placing the securities, in other words raising the money.

Another big advantage of using this method of raising money by creating securities is that we can potentially have *secondary liquidity*, a *secondary market*. When an investor buys the security on the primary market the money they pay is then passed to the issuer. However, this security they have bought is typically a negotiable, transferable instrument. This means that the investor holds something that they should be able to sell on to somebody else, if they wish. This idea is particularly important in the equity market since selling on the shares to somebody else is probably the only way that the investor can remove their funds. Unlike debt, equity carries no promise to repay investors at any time: it is what we call a perpetual product. So, without the ability to sell on this becomes a perpetual investment.

The need for investors to sell their securities to other investors after having bought them in the primary market is why we have the secondary market. The issuer is not directly involved in this process; it is simply a change of investor. Money will flow between investors, not between investor and issuer. However. the bank can again act as an intermediary. They can use their expertise to find replacement investors and sometimes even stand in to take on the securities themselves in order to promote liquidity. We will talk more about this role of the intermediary in the next sections.

In the secondary market the bank is not paid by the issuer but instead will make their profit from the difference between where a seller is willing to sell and a buyer is willing to buy – this is called a *price spread* – or by charging commissions to both the buyer and seller. Both models are used in the markets and, again, we will talk about this a little more in the following sessions.

Risk and Return

To make our model work we need to have the flow of funds from those that have to those that want. Those that have the funds need to be tempted to provide them and at the heart of making the decision to invest, to provide the funds, is the consideration of how much risk is being taken and the potential return from doing so.

As we saw in the primary market, the investor is essentially placing his funds with the issuer for either a known amount of time or, potentially, forever. It is normal, therefore, that an investor will want to make a return on their investment, either through income and/or through capital appreciation.

Thinking about the risks there are some very big ones related to the investment not performing as expected, and examples of this could be:

- A borrower does not make an interest or redemption payment.
- Or, a company that has issued shares but then becomes bankrupt thereby losing all the shareholder funds

These are quite significant risks but there are also more subtle ones such as changes in perception of the issuer and its prospects (reputation) which can affect the value of investments. The size of the return on an investment will, hopefully, be a product of the amount of risk that the investor is taking. We have had to add the word “hopefully” to this sentence because the process of analysing risk and return is not perfect and, even more significantly, it is dynamic.

This means that what may appear to be a very low risk investment today, in other words a very safe credit, may turn out in a few years' time to be very high risk. An example of this can be seen with Ford Motor Company in the 21st century.

Ford

Ford is a large, well-established firm with a long history in financial markets. Coming into the 21st century they were a solid investment-grade credit, with a rating by Moody's of A1. Moody's is a credit rating agency, whose role we will discuss in our Section on Debt, and when we say that a credit is investment grade we mean that the rating agency believes this it is safe to lend to this issuer as, based on the evidence of today, it seems probable that they will be able to repay. A1 is a rating given to very many issues so is seen a s a good, safe rating.

By 2008 things had changed for Ford. During that eight year period they ran into serious problems with liquidity and also within the economy and the car industry: a perfect storm for them. This meant that Moody's kept reassessing how safe it was to lend to them and reducing their credit rating as a result. One significant movement was in 2006 when they downgraded Ford to below investment grade. This is called Speculative grade, and again we will look at this further later in our material. For the moment, though, the key thing to realise is that when an issue becomes speculative grade there is a rapidly increasing probability that it will not repay its debt. Things carried on going down until 2008 when Ford was given a rating of Caa1, a very weak rating suggesting the company was in a lot of trouble and with quite a high probability of defaulting.

They stayed at these lowest levels for most of 2009 until in November of that year the rating agency could see signs of improvements and started to upgrade Ford, gradually, taking five years until in 2015 they were finally investment grade again.

Sadly, the story does not end there. After a couple of years of stability, and even gentle improvement but then in 2018 the liquidity issues arose again, causing a fall in rating until the end of 2019 saw Ford once again becoming speculative grade.

So we can see from this a pattern of a well-established credit going from a long period of stability, for more than twenty years its rating was around that A1 level, into a period of quite rapid decline, followed by a rally, only to then head into decline again. What will happen in the future is anyone's guess.

This case study exemplifies why the investor always needs to be aware of changes in risk throughout their investment.

We also need to think about the issuer in this scenario, at least in the primary market. They are raising funds and so they will have their own needs and desires when it comes to determining the cost of these funds. Remember this cost will be either the interest rate they will pay on debt or the price at which they will sell their equity. It can easily happen that the rates needed by the issuer and investor are not compatible.

Again, it is the job of the bank to manage expectations on both sides and to try to find the level at which both sides are happy to ensure a successful issue. If this cannot be achieved then it would be best for the deal not to be brought to the market at all.

In the next section we are going to take a closer look at the key players in the market: the issuers, investors and intermediaries, and also some of the other entities that you will encounter. We will consider their motivations for using capital markets and also how some of these entities have influenced the markets we see today. Before that, though, let's just revisit some of the key terminology we have introduced in this section and then try our hand at a few questions to test our understanding.

Key Terminology

In this section we have introduced some key terminology which we need to ensure we understand. The following is a brief summary:

DISINTERMEDIATION:
this is the process of facilitating a movement of funds without a bank standing in as direct intermediary between the two parties. It leads to the creation of securities, debt or equity, as a means of moving money

LIQUIDITY RISK:
this is the risk that a bank may lose access to funds and so will need to find a replacement, which may not be possible or profitable. In brief therefore, liquidity risk is the risk that we may not be able to find funding or be able to sell an asset and so end up with limited or no liquidity to unwind our exposures

CREDIT RISK:
this is the risk that a counterparty might default and therefore a loss is incurred because of their failure to pay

WHOLESALE FUNDS:
these are large amounts of money. We were purposely not specific about what constitutes "large" in this case as that will differ from market to market, but it will be much greater than retail funds

RETAIL FUNDS:
In contrast to wholesale funds these are small size funds. They are called retail because the size could be the sort of size an individual in the market might have available but it is also an expression used for small corporate funds

PRIMARY MARKET:
this is the stage of disintermediation where securities are created and money moves from investors to issuers

SECONDARY MARKET:
this is the stage that allows secondary liquidity by replacing investors in products that have already been issued in the primary market. Funds will flow from investor to investor, rather than from investor to issuer

1.1 Questions

Let's go through a couple of questions on the material we have just studied to make sure we are happy with our understanding.If you find you are struggling to answer them you should probably take another look at this section before you move on to make sure you have a good understanding of what we have covered so far.

The answers to these, and all the end of section questions, will be found at the end of each session.

Which of the following is another way of describing a borrower?

A Placer of funds
B Taker of funds
C Intermediary in the deal

Which of the following is an example of disintermediated borrowing and lending?

A A bank lends to a retail customer
B A bank borrows from a corporate customer
C A bank arranges a bond deal for a corporate customer

Can you explain the difference between the primary and secondary markets?

We have said that an equity is a perpetual security: what does this mean?

A A security with an unknown redemption date
B A security with no redemption date
C A security with an unknown redemption amount

Section One

1.2 Key Players

Key Content:

- Identifying the key players (issuers, investors, intermediaries), both direct and indirect participants
- Understanding their motivations and impact on the markets
- Impact of key regulation such as Basel III and the Dodd-Frank Act

In the first session we identified the differences between raising money through traditional banking and raising money through the disintermediated financing method of issuing and investing in securities. In this section we will take a closer look at what kinds of firm will take on these roles of issuer and investor as well as considering what they would gain from using these markets.

Whilst we are still concentrating on making sure we understand the capital markets, focussing our attention on the roles played in the raising and placing of funds, we will also see that it is by combining all the parts of the financial markets together makes using those markets so attractive.

For example, a company in Iceland may want to raise money in a currency other than the Icelandic krona, and from investors outside of Iceland. Without the foreign exchange market this would be impossible but happily by combining a debt or equity deal with the relevant foreign exchange trade it is not just possible but commonplace.

Direct Participants – Issuers, Investors, Intermediaries

So far we have followed the path of funds as they went from those that have, the investors, to those that want, the issuers, with the participation of a bank acting as an intermediary either directly or as a facilitator. So we have seen issuers, investors and intermediary and these are considered the *direct participants* in the market as they are directly involved in the flow of funds. Also, more broadly, they are going to be the buyers and sellers in all the parts of our financial markets. Each of them has an important role, or roles, to play so before we look at some specific types of player in the market we will summarise the general role of issuers, investors and intermediaries.

Issuers

These are the entities that are looking to raise wholesale funds. Often, for them raising the funds by issuing securities in the capital markets is a choice as there may be the alternative of bank borrowing.

As we know, though, a company may not always want to borrow money but instead want to sell a part of themselves. If this is the case then they will need capital markets to achieve this.

The size of funds required is also something to be considered: there can be a critical size of borrowing that the bank lending market might not be able to cope with. A good, large institutional customer should be able to borrow $1 million from their banking partners with no difficulty but if we substitute billions for millions they will quickly use up their credit lines and may find the funds become unavailable.

A final point for issuers is that using the capital markets can often mean an improvement in the rates they pay to raise money, relative to that offered by traditional banking. The more potential investors there are for a deal the finer the rates can become and as we focus our attention on international capital markets we can see that our universe of potential investors seems to be pretty much ever expanding.

Investors

These are the entities with funds to invest.

Financial markets can really help these investors to diversify their risk and maximize their returns by giving them a wide range of alternatives for investment. They will be the buyers of the capital market products that have raised funds for the issuers. This again highlights how useful these markets are in allowing investors to diversify and therefore help them to manage any associated risks.

Sometimes investors will be investing their own funds but we will also come across professional managers of other people's funds, often through collective investment schemes. We will see, below, how these firms offer expertise in selecting the best investments to achieve target returns, highlighting what we have previously said about risk and returns.

Financial Market Intermediaries

These are the firms that put together the buyers and sellers – the providers and takers of funds.

As we have seen, they have a role to play in the primary markets by creating the financial instruments and in the secondary markets by facilitating the replacement of investors.

In the primary markets the intermediaries will often underwrite deals meaning that they will guarantee the availability of funds to the issuers. This means that during the process they may have to step into the role of investors but their intention is that this should be very short-term as they look find long-term providers of funds. This underwriting is to ensure the issuer gets the funds that they need when they need them. As we saw in our first example this is called providing liquidity.

In the secondary markets intermediaries can also take on a role of providing liquidity to investors and this is by acting as a principal in the deal. In the purest form of disintermediation the intermediary would literally just pass trades through. This is called a flow deal in which they act as a broker putting the two sides together. Sometimes, though, they may have a seller on one side but no buyer on the other side. If this happens the intermediary may choose to step into the deal as the buyer so becoming a principal in the trade and taking on a risk position. This is part of the process of trading that we will look at shortly.

Direct Participants – Individuals and Institutions

So now we can now take a look at some of the entities that fulfil these roles in the markets, looking firstly at individuals and then moving on to different types of institutional players. These will be the players that we will find in the markets. One thing we should expect to see is that different types of player will typically take on different roles, at different times and for different purpose. Just because an institution is an issuer today does not mean that it will not be an investor tomorrow, all dependent on their need.

Individuals

Individuals probably have the most straightforward role in the markets. As we have seen they can be investors but will not be issuers or intermediaries in the capital markets. For the most part their transactions will be small in value and so will be defined as retail deals. Of course, there are some very wealthy individuals whose trades will not be small in value, and if these individuals invest directly in the markets, as opposed to using a third-party professional money manager, they will often create investment companies. They would do this for a number of reasons including greater tax efficiency.

Furthermore, because managing wholesale money is time-consuming it would be more efficient to do so as a corporate structure (institutional investor) rather than as an individual. Whilst individually retail deals may be small and can be assumed to have little impact on the market, collectively they are a very important source of funds. On the primary market deals may often be structured to attract retail investors, particularly in the equities market, and their enthusiasm, or lack of, for a deal will be reflected in the pricing set by the intermediaries.

Institutions

In this part of the material we are going to look at a number of different types of institution. Since these are our major players we can expect to see them as issuers, investors, intermediaries or maybe all three. To help us to keep them clear in our minds we will divide them into financial and non-financial institutions so we can see how the patterns of their involvement will develop.

Let's begin with **non-financial** institutions.

Non-Financial Institutions

Governments

It may seem strange to think of governments as being participants in the financial markets but in fact they are very large, important participants, both as issuers and investors. Most countries tend to run deficits and the capital markets are the perfect way for them to raise the funds they need. Clearly you cannot buy shares in a country so it is the debt market that will be used by this group of institutions and, typically, on a very regular basis.

Later, in our section on Debt Markets, we will discuss the significance of government borrowing not just for the raising of funds, but also as a benchmark that we will use to determine the correct rate at which other borrowers should be able to use the market.

Governments can also be investors, again preferring to invest in debt rather than equity. Whilst needing to raise money to fund, say, infrastructure projects, a government will also want to maintain some reserves, either in their own currency or another. These reserves will not just be cash balances but will also need to be invested and so they will look to the markets to get the best returns.

As both investors and issuers governments tend to move large sums of money and so using the markets is a very efficient way of doing this. They can also vary their maturities and currencies, depending on market conditions. It is not that unusual to see governments borrowing money for 30 – 50 years which is a typical example of a maturity range that is achievable in the capital markets but would be very difficult in the banking market.

As an issuer they borrow money in the name of, perhaps, that country's Treasury but it is clear that the debt is the obligation of the country. As an investor we will typically see the trades carried out by a government agency, such as the central bank for instance who will be acting as the government's professional money manager.

If you want to know more about this you could take a look at the UK's Debt Management Office (DMO) website. The DMO is the agency that manages debt and cash management for the UK government and can be found at: www.dmo.gov.uk

Supranational Agencies

These are agencies that are owned by more than one country. Examples are the World Bank or the European Investment Bank. Both of these are examples of development banks which are banks that manage money for economic development projects and are typical of the sort of supranational that tend to use the financial markets. As part of the process of managing money they will be responsible for raising funds which they typically do in their names. These names are considered very safe because they are owned by the major economies, so therefore are very unlikely to default.

As is the case with governments the supranational agencies cannot issue equity as ownership of one of these development banks is by invitation, but they can and do regularly use the debt market. Again we see that the size and flexibility of the capital market offers a great advantage to these issuers.

These agencies are also investors, although they are larger borrowers. As investors they need to be accountable to their shareholders who will pledge funds every year to the bank and its projects. These funds will need to be invested until used and so these agencies tend to run portfolios of financial instruments that can easily be sold on the secondary market, which, again, is one of the key points about capital markets.

More information about the activities of the World Bank in financial markets can be found at: www.treasury.worldbank.org

Corporations

By corporations we mean simply companies that will need to raise money to carry out their business, both in terms of day-to-day running of the firm and to finance growth and expansion. Unlike governments and quasi-sovereigns, corporations can use both debt and equity markets to raise the funds they need so giving them the maximum potential investor coverage. Most companies will tend to be net borrowers but as is the case with the other participants they can also be investors and, in some cases, they can hold large amounts of cash.

It is worth noting here that shareholders are rarely happy with companies stockpiling cash unless they are able to invest these funds to achieve a good return, better indeed, than investing in the core business of the firm. We will come back to this discussion in our session on Equities when we consider dividend policy which is how companies decide to distribute profits, and excess funds, to their shareholders.

And now we can turn our attention to the **financial** institutions.

Financial Institutions

Banks

The institutions we have looked at so far have been both investors and issuers in the market. Now we are going to look at a group that fulfils not just these two roles but will also be intermediaries in the market.

In our explanation of disintermediation we used an example of a bank facilitating the borrowing and lending, and banks are our most obvious intermediaries. However, as banks need to finance themselves, they are corporations after all, they will also be issuers and investors. A big difference, though, between banks and other corporations is that the banks use money not just to fund themselves but it is also their core commodity that they are buying and selling. As we have already said they may not have a perfect balance amongst their customers providing and receiving funds so they often have to be proactive in going out to the markets to raise and place funds.

There are essentially two models of banking: *commercial* and *investment banking*. Commercial banking is best described as traditional corporate and retail banking, at the heart of which is the business of providing direct borrowing and lending opportunities. So, we could say that this is the classic banking business that we described earlier. Investment banking, by contrast, is the business of raising finance and providing investment and so is more involved with capital markets. These days most of the major international banks are combinations of both commercial and investment banks and are commonly known as *universal banks*.

Banks are very well placed to carry out the intermediary function in both primary and secondary markets, particularly if they need to underwrite an issue or take positions to facilitate liquidity. This is particularly true of the larger banks who are able to take on proportionally greater risks. This will not be uncontrolled risk, though, as we will see shortly when we look at the role of the regulators in the market.

Brokers

Broker is an expression often used in the markets with differing precise definitions depending on the context. In its purest sense it is the business of acting as an intermediary between buyer and seller. In that context, brokers do not take any risk, they merely facilitate the transaction between a buyer and a seller of a security. Having said that, banks are often called brokerage houses when describing their secondary market activities which involves the business of moving investments from one investor to another, but sometimes they may have to temporarily be the seller or buyer, although this is only for a short period until the customer is able to step in to the trade.

As well as broking with and between customers there is also another model of broking known as Inter-Dealer Broking. This is not a function carried out by banks but instead by independent, impartial companies. The inter-dealer brokers (IDB) are these non-bank firms whose role is to provide liquidity amongst the intermediaries, also known as the Dealers . The largest IDB is a company called ICAP who has built expertise across many market areas and provides many trading platforms that can be accessed by the intermediaries. These platforms allow the intermediaries to show prices at which they are willing to deal so providing them not just with an easy way to execute their deals but also market transparency.

Asset Management Companies

These are the professional money managers. Their business is investing money, sometimes the money of their own firm but very often the money of other stakeholders.

To take an example, Blackrock is one of the world's largest asset management firms managing trillions of dollars worldwide. Their job is to take money given to them to manage by various stakeholders, both corporate and individual, and invest these funds to get the best returns – for a fee. What they offer is expertise in the form of dedicated managers who will take responsibility for making the best investment decisions, in line with the stakeholder's view on risk and return.

Sometimes the stakeholder will be able to specifically instruct the manager of their funds on how to invest and we will then call this source of funds managed money. These instructions become the *criteria* under which the fund must be constructed and run, and the manager's responsibility is to stay within these criteria. This managed money service is quite time consuming, both in setting up the portfolio, which is making the initial investments, and afterwards in running the fund. Running the fund means making sure that the investments made are always the best available to maximize returns, within the criteria, and again since this is going to be time consuming it will inevitably be expensive.

For this to be economical, then, the fund manager would need to have a reasonable size of funds to put into the market or the process cannot be cost-effective. So, whilst theoretically this service could be available to both institutional and individual customers on the individual side it is typically only offered to *high net worth* individuals who will normally have several hundred thousand dollars, or more, to invest.

Blackrock's customers will include institutions and these high-net worth individuals, for whom they are managing money, but they also run a number of *collective investment schemes*. These are portfolios designed by the fund managers but not for any one specific customer. Instead they are publicly offered, targeting a range of customers, both big and small. The process begins with defining an investment plan that is then publicly marketed. Potential investors consider the plan and make the decision as to whether this investment portfolio would fit their needs, their own criteria.

As an analogy we could consider managed money as being like buying a tailored suit, something made to fit a particular customer, whilst the collective investment scheme is more of an off-the-peg solution. It may not be a perfect fit but the investor decides whether it is close enough to satisfy most of their needs. To help with this, Blackrock offers a wide range of funds covering various markets and risk profiles, and, of course, projected returns. When an investor decides to invest in the fund their money is pooled with all other investors, and so they are then able to benefit from all the economies of scale that the fund manager can achieve as well as receiving their investment expertise.

The asset management industry is a very competitive one and companies like Blackrock are constantly being compared to other firms running similar portfolios. At the end of the day, if the stakeholder feels that Fidelity Investments, another major asset management company, could achieve a better return on their money than Blackrock they will move their funds. This is why the fund managers must always strive to achieve the best possible returns within the criteria. The largest schemes, though, will attract billions of dollars from both retail and institutional investors, depending, of course, on performance.

Sometimes a fund is not run by a human fund manager but instead by a piece of software. These funds are often what we call tracker funds. The idea is not to try and beat the market by building up the most efficient portfolio but instead just to invest in a representative portfolio of a particular market sector.

As an example if we had investor who was only interested in investing in the equity of the largest UK companies, probably because the investor felt that these were the safest companies in the market, then we could create a FTSE 100 tracker fund. The FTSE 100 is a market index that measures the performance of the 100 largest companies in the UK[1] and the tracker fund is one that replicates this index and so tracks its performance. If our fund is only going to invest in the constituents of an index we do not need a human being to run this portfolio. The only time the portfolio would change would be when the constituents of the index changes. So, designing a piece of software to take on this management is actually very cost effective and these savings can be passed on to the investor in the form of lower fees. Naturally since this fund is tracking this market index it can never outperform the market and this is why we call this type of investment passive investment.

We have said that our professional asset managers often look after other people's funds but we can also see professional managers employed to look after the funds of the company for which they work. An advantage to managing these funds in-house is that the individuals working within the company would become more aware of the particular requirements that this corporation might have on its funds, and so would be able to plan a portfolio with this in mind in terms of secondary liquidity etc. Also, their proximity to the company would mean that they would be able to be very responsive to changes in need as the company tracks its present and future cash requirements.

Indirect Participants

In this final part of this section we are going to take a look at a few of the indirect participants. We will view them not so much as issuers, investors and intermediaries, but more as influencers and providers of services to the markets.

Regulators & Regulation

This is one of the most important groups, particularly since the Financial Crisis. The job of national regulators is to protect the integrity of markets in their country, often by ensuring that banks are safe institutions to hold the nation's wealth and that the markets are not biased against individuals, either directly or indirectly. Of course if there is one lesson we learnt in the Financial Crisis it is that whilst we benefit from internationalization of our markets this does not come without risk, and so today we see regulators working together to form international agreements and ensure protection regardless of where the relevant market is situated. The regulators will ultimately be accountable to the government and this is to ensure that any legislative changes that are necessary can be introduced when required. On the whole though the regulators try to work autonomously to encourage good practice and ensure that they are informed about what is happening in markets in order to avoid any more market shocks.

[1] We will come back to equity indices in our session on Equities

US Dodd-Frank Act

Since the Financial Crisis there have been significant regulatory changes in the markets which have been a combination of completely new regulations and the updating of existing ones. This process is still ongoing and the intention, clearly, is to ensure that the intermediaries in the market are safer, less risky entities than they were before the crisis. One of these pieces of legislation, which has had a major impact on the market, is the US *Dodd-Frank Act* (Dodd-Frank Wall Street Reform and Consumer Protection Act). This Act fundamentally changed the role of US banks, not just in the US, but wherever they were transacting business in financial markets.

Amongst the many changes required by this legislation is the *Volcker Rule*, which prohibits proprietary trading by US banks in most instruments. *Proprietary trading* is where the banks would take short-term positions in financial instruments for the purpose of making profit. This is principal trading as we described above, but the intention of classic proprietary trading is to run positions (meaning that the proprietary trader would, for instance, buy shares, hold them (run the position) and then sell them hopefully for a profit) for profit as opposed to providing liquidity in the markets.

The problem with taking these positions is that sometimes they would not be profitable and this could cause the bank to run into financial difficulties. The view of the Volcker Rule is that this risk is unnecessary, but at the same time recognises that sometimes a bank will need to take a position in order to support liquidity. The compromise, therefore, is that the banks are only allowed to take on proprietary trading positions in order to facilitate trade flow, meaning that any positions should be held for only a very short time period.

This ruling has obviously proven to be very contentious but the US authorities have rigidly stuck to the rule, and as a result the European regulators are now working on a version to apply to the large European banks.

If you would like more information on the Dodd-Frank Act you can find it here:
www.cftc.gov/LawRegulation/DoddFrankAct/index.htm

Basel III

Another important piece of legislation is the international Basel III Regulation. This is the latest in a series of regulations intended to ensure that the banks are safe by holding enough capital to fulfil their role as market intermediaries. In our earlier examples we have looked at funds moving from those that have to those that want, via the intermediaries. We have also said that sometimes the customers on the two sides of the deal will not perfectly match and so the bank will put together portfolios of borrowers and lenders causing the credit risk of the deal to be bank to customer, on both sides. The Basel III rules ensure that the banks consider how likely it is that there would be any defaults or changes in liquidity in these trades, and also to make sure that, on a probability-adjusted basis, they would have the funds to stand by their obligations.

The Basel regulations famously works with a three pillars concept, with the three pillars being:

- Minimum Capital Requirements
- Supervisory Review
- Market Discipline

Minimum Capital Requirements

This requires banks to consider the risk of their lending and investment activities. In broad bands they need to define the risk of the types of deals they are making and the counterparties with whom they are dealing, and they then need to apply risk weightings to these transactions. These risk weightings will essentially tell them the minimum that they are required to have in their reserves in case anything were to go wrong.

Supervisory Review

This acknowledges the need for financial institutions to be supervised and sets out processes and tools to be used by regulators to achieve this. This will include requirements for regulatory reporting of trades and exposures, and also guidance on how calculations are to be made in order to ensure consistency.

Market Discipline

The principle behind this is that the more the market participants, particularly banks, disclose about their overall position, the better able we are to understand their overall risk profile. We have a great fear of systemic risk in the markets, the risk that a failure of one, for example the failure of a bank, will lead to the failure of many, meaning that one bank failure could lead to other banks failing because of their inter-related businesses. So as part of the market discipline pillar banks are required to make at least semi-annual announcements of their capital and risk positions so that other market participants can evaluate the risk of doing business with them.

The first Basel Accord was brought into the market in the 1980s, and we are now seeing the implementation of Basel III, first introduced in 2010/2011 but is an ongoing process with some of the changes agreed in 2016 and 2017 known, by some, as Basel IV. Each of these standards continues the work of ensuring that through abiding by these principles the banks have considered broadly the implications of the risk that they are taking and on, and prescribes capital requirements not just in terms of size but also liquidity. Despite its European name this is not just a European regulation: it is essential that Basel III is internationally accepted, which is why the introduction of these rules has to be carried out over a significant period of time to allow for international agreement and amendments.

Infrastructure Providers

In the rest of our material we will talk about how financial products are traded and one of the first distinctions we will make is between products that are traded OTC (over the counter) and those that trade on official exchanges (e.g. The London Stock Exchange).

These exchanges are examples of infrastructure providers. Their role is not to be part of the flow of funds but to provide the environment where trading can take place, and associated with this, the collecting and reporting of information about the trades. This helps to promote transparency (easily observable and available information) and provides very important information to the regulators about how efficiently the markets are working. When we come to our sessions on Equities and Derivatives we will talk more about these institutions, how they work and what they offer.

Before then, though, we should say a little about some of the other infrastructure providers such as data and financial application vendors. We will also see as we go through our material that the markets generate a lot of information and this information is constantly being recycled and analysed to try and determine the next movements in the market. This means that the companies that provide this data and the tools for analysis have a very important role to play here.

Two of the most well-known examples of these are Bloomberg (www.bloomberg.com) and Refinitiv (www.refinitiv.com). In both cases they provide not just data but very sophisticated applications for analysis and, increasingly, they are taking on the role of broader infrastructure providers as they provide trading platforms and even trade repository services, where they collect data about transactions on behalf of the regulators. So significant is their input these days that a failure in service of one of these companies can literally cause the market to have to stop trading as the direct participants are unable to carry out their business without this flow of information and the utilities provided by these firms for analysis and execution of trades.

So we can see that whilst the direct participants are the ones that move money from those that have to those that want, the markets of the twenty-first century require input from a range of other players to ensure that these funds move smoothly and efficiently. One of the ways that the markets have evolved is through finding new methods for doing this, either through technology or the creation of new financial products, and this evolution is a major part of what makes the markets so interesting.

As we carry on looking at the parts of the market we will come across these players again and see how they use the products that we will be describing. In our next section we will take a look at trade flow and identify the key areas within a firm involved in this activity.

Key Terminology

Below is a summary of some of the key terminology that we have learnt in this section:

DIRECT PARTICIPANTS:
these are participants directly involved in the flow of funds

INDIRECT PARTICIPANTS:
these are participants that are not directly involved but are significant in the markets, providing regulation or infrastructure support

ISSUERS:
the entities looking to raise funds in capital markets

INVESTORS:
individuals and entities looking to place money in the markets

INTERMEDIARIES:
the firms that facilitate the movement of funds in primary or secondary markets

UNDERWRITING:
the commitment of an intermediary, usually a bank, to guarantee funds to an issuer

PRINCIPAL TRADE:
a trade in which a position is taken and held by an intermediary as opposed to being passed on to another natural counterparty

FLOW TRADE:
a trade in which the intermediary passes the position from seller to buyer, standing in as counterparty to trade only momentarily and so not taking a position. Also known as broking a deal

COMMERCIAL BANK:
we described this as the traditional model of banking, where borrowing and lending are directly carried out with retail and institutional customers

INVESTMENT BANK:
the business of raising funds and finding investors. More closely tied with capital markets

UNIVERSAL BANK:
this is a bank that carries out both commercial and investment banking, a common model for large banks in the twenty-first century

HIGH NET WORTH INDIVIDUAL:
an individual with a large amount of funds to invest in the markets and whose funds can either be directly invested or managed by professional money manager

COLLECTIVE INVESTMENT SCHEME:
an investment vehicle defined and managed by a professional money manager and open to investment from a broad range of investors, both retail and institutional

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VOLCKER RULE:
part of the US Dodd-Frank Act that prohibits US banks from proprietary trading except for the purpose of supporting liquidity in the markets

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PROPRIETARY TRADING:
running a position for profit

BANK REGULATORY CAPITAL:
this refers to the amount of money a bank is required to hold by the regulators in order to cover potential losses, calculated on a probability-weighted basis

1.2 Questions

As we did before we should now try and answer a couple of questions on the material we have just studied to make sure we are happy with our understanding.

Why is the size of funds that an issuer needs to raise critical to their ability to use the financial markets?

Which of the following cannot be used by a government to raise funds?

A Debt securities
B Bank borrowing
C Equity securities

What is a supranational agency?

A An agency owned by more than one country
B A multi-national corporation
C A high-ranking national agency

How would you describe an IDB?

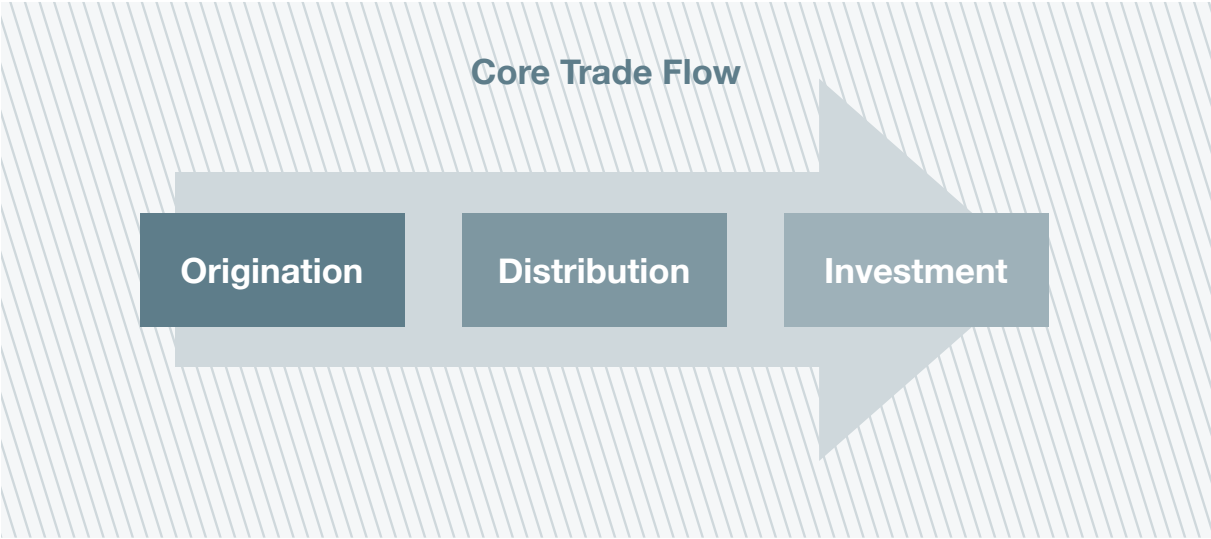
Section One

1.3 Trade Flow

Key Content:

- Inside a financial institution: role of trading/sales: principal and flow business; operations, investment management.
- Buy and sell side defined

In this final part of our first session we are going to take a quick look at the trade flow to identify some of the key areas inside a firm which will be carrying out these activities. This diagram represents the three stages:



Let's take a look at each of these stages and see who will be involved in this part of the process.

Origination

To start at the very beginning we need to have an issuer, an entity with a requirement to raise wholesale funds. This begins on what we call the *buy side*, of the market, where we find issuers wanting to raise (buy) money. Most commonly, in all the institutions (issuers) we have looked at we will find a treasury department and it is this department that will take charge of making sure the institution is funded. This will mean managing bank relationships and lines but also taking responsibility when the institution decides to use financial markets (rather than classic banking) and raise money in the debt or equity markets.

The treasury department should be an expert in understanding how the institution can manage its funds. It will not necessarily, though, be an expert in financial markets and certainly won't have the expertise of knowing how to find the funds. This is why the institution will need to liaise with an intermediary in this primary market process. This intermediary is described as being on the *sell-side*, selling the expertise to access the market.

In the Intermediary firm we will find Capital Markets Origination teams, normally split between debt and equity markets. Their job is to create the most appropriate security to match up with the customer's (the issuer's) needs but also making sure that what they create also suits the investors. Most of the large banks/intermediaries have *corporate finance departments* whose job is to build strong, long-lasting relationships with the issuing institutions who will be looking to use the financial markets on numerous occasions. They interact with the specialist *origination* teams mentioned above, who usually have more in-depth knowledge of what is happening in the markets at any specific time, will create the securities. In the vast majority of cases these deals (new issues) will need to be underwritten, and so we have a further group, the *Syndication* team, whose job is to find other intermediaries who are willing to step in and underwrite the securities to spread the risk and ensure the issuer will receive their funds as quickly as possible.

Beyond these three business units there will also be numerous legal tasks which are a result of the intermediaries carrying out their due diligence. This process ensures, amongst other things, that all information presented to potential investors is accurate and comprehensive and that the securities being created are acceptable to the regulators. Eventually, though, the securities will be ready for the market and then we can move to the distribution phase in order to initially see the money raised for the issuer, the primary market, and then throughout the life of the security, the secondary market.

Distribution

This is where we introduce *trading and sales*, two functions that sit in the front office (or trading room) of the intermediary. Whilst both are defined in broad terms as dealing positions they are two very different jobs. Both of these individuals sit inside the trading room which is generally a very protected environment. This is because these individuals, these dealers, are authorised to commit their firms to large transactions, many millions of dollars at a time. The firm needs to ensure that they know just what is being promised in their name as they have to stand by the deals so these positions are closely monitored with access to the room carefully scrutinised and many security precautions in place to try and prevent misuse.

To look first at the role of the *salesperson* we find these individuals covering both the primary and secondary markets. On the primary market, they will ensure that the deal is first sold, so raising the issuer's funds. To do this they must convince investors that this is a good investment for them. They do this by building relationships with their given group of investors, understanding what are their risk and return requirements. Then they can suggest investments and strategies that fulfil these needs, including, if appropriate, the new issues that are being brought to the market.

As well as selling primary market products the salespeople will also be heavily involved in the secondary market. Again this is driven by their relationships and they continually suggest new investment ideas from the universe of available securities, both new and existing deals, and in many cases this may mean having to replace investments already held so salespeople not only sell they also buy. The key job is an advisory one and from the firm's perspective their key role is to ensure trade flow coming into the firm. This is one of the reasons we are increasingly seeing that salespeople are not necessarily executing trades but more advising and encouraging customers to use the firm's automated trading systems.

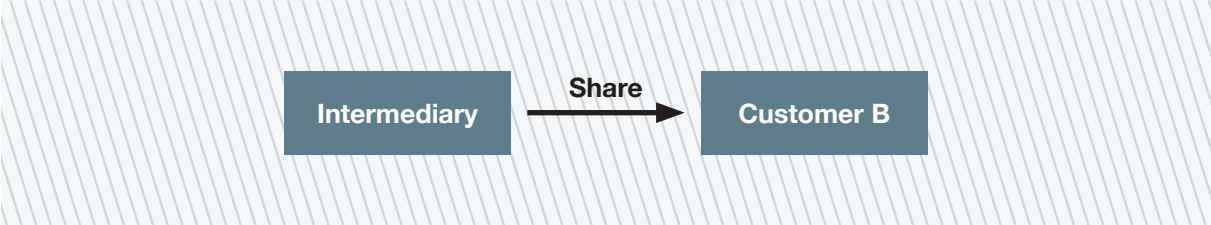
The last few years has seen a marked fall in the number of human salespeople as the use of technology has grown, and a growing proportion of customers have opted for an execution only service. Nevertheless, these individuals still offer valuable insights to customers who are looking for an advisory service.

Traders are the other sorts of dealers that we find in this sell-side function of distribution. Their job is very different from the salespeople. To start, when a customer asks a salesperson for the price of a financial market product it is not the job of the salespeople to determine this value it is the job of the trader. Then if a salesperson executes a deal, they buy or sell from the customer, they are acting as brokers and as any resulting risk position actually belongs to the trader who made the price. It is then the trader's responsibility to manage this position, to either trade it on, complete the flow of the trade, or maybe to hold on to it for a while in the hope of making a profit. This is their choice and is known as position management.

So, we can see here two key tasks of a trader: price-making and position management. Traders are mainly involved in the secondary market as they determine the changing values of financial products after they have been issued and create the prices that are quoted in the market. Their job involves monitoring the markets so that they know when values need to change, for example responding to supply and demand, changes in the economic, etc. As we have said they also manage positions.

Let's take an example that a customer wants to buy a share in ABC Corporation, this is Customer B. The salesperson makes this sale but the responsibility for managing it falls on the trader who set the price. If there is another customer who simultaneously wants to sell a share in ABC Corp, Customer A, the deal will flow through the intermediary:

However, if Customer B buys their share but the firm does not have an immediate matching offset on the other side, they end up with a principal trade:



So it is the trader who will take responsibility for trading out of this deal as profitably as they can. Traders find themselves having to assimilate a lot of information from various sources to ensure that what is being passed to the customers, either through human salespeople or on a bank to customer dealing system, is accurate and up-to-date. At the moment this is primarily the job of a human but increasingly this is being done by computer programs, known as intelligent algorithm systems (algorithmic trading). We will talk a little more of this in our session on FX.

Investment

The final part of the flow is investment. No matter who the investor, whether it is one of the asset management companies we have discussed or whether it is an individual, their motivations will still be the same: to get the best return for the acceptable amount of risk. This is the job of the fund manager. It is worth noting that this individual could be called a fund manager, an investment manager, a portfolio manager, even money manager, but they all mean pretty much the same thing.

This individual is making the investment decisions. In the wholesale markets this can mean considering a broad range of potential investments and if the money is being managed on behalf of a third party these decisions will also have to be justified.

Most investors take a long-term view and will balance capital appreciation with income to work out their optimum investment and making this decision is normally the result of careful study of the markets and comparing potential investment strategies. Once they have invested their funds their work is not finished as we have said the fund will need to be run, constantly checking to ensure they have the best investments to try and outperform the market, a process known as active investment. So this is why we see these investors in not just the primary markets but also in the secondary markets, evaluating all possibilities.

We said that the issuers were considered to be buy-side participants, and the intermediaries sell-side, so we need to think about which title to use for investors, and the answer is buy-side. This time we can define this as being because they are buying the investment product. In fact whenever we talk generically about the buy-side of the market we are most commonly talking about the investor community as they are most frequently active buy-side participants. Issuers may only come to the market one a year, or in many cases less often, but investors will be seen far more regularly.

Operations

Stepping outside the direct business flow we need to consider one more business area that is not included in the diagram above and yet it is a really important area covering all three stages, and this is Operations. On the secondary market we have spoken about buying and selling financial products and on the sell-side it is the traders and salespeople who execute these deals and on the buy-side is the fund managers; in the primary market it is the treasury department that authorises the creation of securities and Origination who create them and arrange the primary sale, often using salespeople to execute the deals. But we should realise that this is not the end of the process. The trade is where the contract to exchange securities and move money is executed and beyond that someone needs to ensure that this exchange takes place and this is part of the role of Operations. Specifically this is known as settlement of the trade.

Operations will take responsibility for, amongst other things, calculating and informing values to be exchanged, sending instructions on how settlement will take place (bank account details, information about where securities need to be delivered etc.), ensuring that money and/or assets are in place to meet the requirements and maintaining all the books and records of the trade. Today, participants place a great deal of value on operational efficiency and so this department has become far more high-profile and valued in recent years, as well as coming under more regulatory scrutiny.

Operational support is needed in all three parts of our trade flow and whilst intermediaries will always run their own operations departments some investors will find it more cost-effective to outsource this, often to the banks. Issuers will also need operational support to ensure that payments are made to the investors etc., and again this is a service typically offered to them by the intermediaries who create the securities on their behalf.

ICMA appreciates that this is a really important part of ensuring efficiency in financial markets and so they offer a number of specialist Operations training courses to provide much more detail on this topic. So, if you would like more in-depth training at the Foundation level you could consider the Securities Operations Foundation Qualification (SOFQ) and for a much deeper understanding of the role and processes of Operations this could be followed up by studying for the Operations Certification Programmme (OCP).

Key Terminology

Below is a summary of some of the key terminology that we have learnt in this section:

BUY SIDE:
this is what we call those who are involved in raising or investing funds

SELL SIDE:
this is the other side of the fence from buy side, the functions involved in facilitating this movement of funds

CAPITAL MARKETS ORIGINATION:
the area of an intermediary that takes responsibility for providing financing solutions to institutional customers, specifically in the debt and equity markets

SYNDICATION:
this is the process of finding underwriters for a capital market deal to spread risk.Intermediaries who are active in the primary markets will have syndicate teams who will build relationships with other intermediaries and take responsibility for inviting these intermediaries into deals to build the syndicate group as soon as a deal is launched in the market

SALESPERSON:
this the person in an intermediary firm who liaises with investors, advising them on investment opportunity and executing trades with them

TRADER:
this is the person who is charged with managing the intermediary's positions and providing pricing to customers.A key difference between traders and salespeople is that the sales function is a broking function, whilst the trader is a risk-taker.All trades executed by a salesperson are ultimately the responsibility of a trader

SETTLEMENT:
the process of exchanging money and/or assets after a trade has been executed

1.3 Questions

Let's go through a couple of questions on the material we have just studied to make sure we are happy with our understanding.

In which part of the trade flow is Corporate Finance involved?

A Origination
B Distribution
C Investment

Sales and trading are both front office functions, but how do they differ?

Which department manages the settlement of trades?

A Sales
B Operations
C Syndication

Which piece of market regulation restricts US banks from taking proprietary positions?

A Basel III
B Dodd-Frank
C MiFid II

Section One

Conclusion

This brings us to the end of the first part of our material. In this part we have set the scene for what is to follow. We have looked at the basic idea of financial markets and have moved on to consider the role of issuers, investors and intermediaries. We need to bear these in mind, as well as some of the individual roles within intermediaries, as we move on to look at the different market sectors.

In our next session we will look at foreign exchange usually abbreviated to "FX". This is the one truly international financial market which gives us the means to change currencies and therefore open more avenues for issuance and investment.

Before you move on it would be best if you felt confident that you understood all the ideas that we have covered so far – don't forget you can always ask questions on the Discussion Board!

Finally, we have one more little quiz for you which consists of 5 questions in the style of the FMFQ exam as a practice.

Section One Practice Questions

If an investor wishes to sell a security before its maturity date they are reliant on which part of the financial markets?

A Primary market
B Secondary market
C Tertiary market

What is the name of the international regulation that applies to banks and aims to make them safer, better capitalised institutions?

A Basel III
B Dodd-Frank
C MiFID

If you enter a trade where you sell something you do not own how would your position be described?

A Flat
B Long
C Short

What type of company is Refinitiv?

A Bank
B Asset management company
C Data and financial application provider

Which of these organisations will be seen as issuer, investor and intermediary?

A Bank
B Supranational agency
C Asset management company

1.1 Answers

Which of the following is another way of describing a borrower?

A Placer of funds
B Taker of funds
C Intermediary in the deal

The answer to this question is B) Taker of funds. The borrower is the one that is looking for funds in the market and is willing to pay the interest rate.

Which of the following is an example of disintermediated borrowing and lending?

A A bank lends to a retail customer
B A bank borrows from a corporate customer
C A bank arranges a bond deal for a corporate customer

Disintermediated financing is the model where the bank is not directly involved in lending and borrowing and so answers A) and B) are incorrect. The correct answer, c), references arranging a bond which is a typical capital market debt product and a perfect example of disintermediated financing as the buyer of the bond provides the funds for the issuer.

Can you explain the difference between the primary and secondary markets?

The primary market is where the securities in disintermediated financing are created and initially sold into the market. This is how the funds are raised to be passed to the investors. The secondary market is where the market tries to provide secondary liquidity. This happens by investors buying and selling the financial products, so replacing the provider of funds. Typically they rely on intermediaries to find these buyers and sellers, using their contacts and expertise to find the greatest potential investor base. Remember the issuer is not involved in a secondary market cash flow, this is all about the investor side of the fence.

We have said that an equity is a perpetual security: what does this mean?

A A security with an unknown redemption date
B A security with no redemption date
C A security with an unknown redemption amount

The answer is B) A security with no redemption date. When a perpetual security is created it means that the funds are given in perpetuity, the investors have no right to receive their funds back from the issuer. Equities are normally perpetual securities and debt are not, although we do have some examples of perpetual debt securities but they are very rare.

1.2 Answers

Why is the size of funds that an issuer needs to raise critical to their ability to use the financial markets?

The capital markets are for raising wholesale funds. So if an issuer wants to raise too little money they will not be able to use the markets, and nor would they would be cost-effective even if available. Similarly, but contrarily, the bank lending market often finds difficulty in raising large sums of money so if an issue is looking for a large amount this may not be available in the bank market, and again might not be cost-effective, and so this is the perfect scenario for using capital market products.

Which of the following cannot be used by a government to raise funds?

A Debt securities
B Bank borrowing
C Equity securities

Governments cannot issue equity so this market cannot be used by them.

What is a supranational agency?

A An agency owned by more than one country
B A multi-national corporation
C A high-ranking national agency

A supranational agency is one owned by more than one country. Examples we looked at were the World Bank and the EIB.

How would you describe an IDB?

An IDB (Inter-Dealer Broker) is an intermediary that deals with the wholesale players in the investment side of the market, buying and selling from them (or providing the trading system that allows them to buy and sell with each other) in order to promote liquidity in the intermediary part of the market. They do not take positions and they do not deal with customers, except the very largest wholesale customers who have significant impact in the market.

1.3 Answers

In which part of the trade flow is Corporate Finance involved?

A Origination
B Distribution
C Investment

Corporate finance is the department that liaises with potential issuers so it is involved in the Origination part of the process.

Sales and trading are both front office functions, but how do they differ?

Whilst both being dealing positions, authorised to deal in the name of their firm, the salesperson does not take positions. When they deal they are dealing on behalf of the trader. The prices they quote will be given to them by the trader whose responsibility it is to ensure that they are accurate. The salesperson's job is to liaise with customers, whilst the trader does not typically talk to a customer, their external interaction will be with other intermediaries such as IDBs and other banks.

Which department manages the settlement of trades?

A Sales
B Operations
C Syndication

The answer is B) Operations. The settlement of a trade takes place after execution and is the responsibility of the Operations department who must ensure that all money and/or assets are in place and instructions have been sent correctly to avoid trade failure

Which piece of market regulation restricts US banks from taking proprietary positions?

A Basel III
B Dodd-Frank
C MiFid II

The answer is B) Dodd-Frank. This falls under the Volcker Rule which was one of the most contentious parts of this regulation, introduced just after the financial crisis and designed to make US banks safer in future.

Section One Practice Answers

If an investor wishes to sell a security before its maturity date they are reliant on which part of the financial markets?

A Primary market
B Secondary market
C Tertiary market

What is the name of the international regulation that applies to banks and aims to make them safer, better capitalised institutions?

A Basel III
B Dodd-Frank
C MiFID

If you enter a trade where you sell something you do not own how would your position be described?

A Flat
B Long
C Short

What type of company is Refinitiv?

A Bank
B Asset management company
C Data and financial application provider

Which of these organisations will be seen as issuer, investor and intermediary?

A Bank
B Supranational agency
C Asset management company