Chapter 2 Financial Market Environment
Firms that require funds from external sources can obtain them in three ways:

1. through a financial institution
2. through financial markets
3. through private placements

Financial institutions are intermediaries that channel the savings of individuals, businesses, and governments into loans or investments.
Commercial Banks, Investment Banks, and the Shadow Banking System

• The Glass-Steagall Act was an act of Congress in 1933 that created the federal deposit insurance program and separated the activities of commercial and investment banks.
  – Repealed in the late 1990s.

• The shadow banking system describes a group of institutions that engage in lending activities, much like traditional banks, but these institutions do not accept deposits and are therefore not subject to the same regulations as traditional banks.
Financial Institutions & Markets: Financial Markets

• **Financial markets** are forums in which suppliers of funds and demanders of funds can transact business directly.

• Transactions in **short term** marketable securities take place in the **money market** while transactions in **long-term** securities take place in the **capital market**.

• A **private placement** involves the sale of a new security directly to an investor or group of investors.

• Most firms, however, raise money through a **public offering** of securities, which is the sale of either bonds or stocks to the general public.
Financial Institutions & Markets: Financial Markets (cont.)

- The **primary market** is the financial market in which securities are initially issued; the only market in which the issuer is directly involved in the transaction.
  - IPO
  - Seasoned Shares
  - Only time issuer gets funds from investors

- **Secondary markets** are financial markets in which pre-owned securities (those that are not new issues) are traded.
Markets

• The **money market** is created by a financial relationship between suppliers and demanders of short-term funds.
  
  • **marketable securities**
  
  • among the least risky investments available.

• The **capital market** is a market that enables suppliers and demanders of long-term funds to make transactions.
  
  • The key securities are bonds and both common and preferred stock.
Berkshire Hathaway – Can Buffett Be Replaced?

– Since the early 1980s, Berkshire Hathaway’s Class A common stock price has climbed from $285/share to $114,000/share.

– The company is led by Chairman Warren Buffett (80) and Vice-Chairman Charlie Munger (86).

– The share price of BRKA has never been split. Why might the company refuse to split its shares to make them more affordable to average investors?
Broker Markets and Dealer Markets

**Broker markets** are securities exchanges on which the two sides of a transaction, the buyer and seller, are brought together to trade securities.

– Trading takes place on centralized trading floors.
– NYSE

**Dealer markets** are markets in which the buyer and seller are brought together indirectly via computers

– no centralized trading floors.
– The Nasdaq market is one example
– OTC
The Role of Capital Markets

• From a firm’s perspective, the role of capital markets is to be a liquid market where firms can interact with investors in order to obtain valuable external financing resources.
• From investors’ perspectives, the role of capital markets is to be an efficient market that allocates funds to their most productive uses.
• An efficient market allocates funds to their most productive uses as a result of competition among wealth-maximizing investors and determines and publicizes prices that are believed to be close to their true value.
Exchanges

- NYSE
  - http://www.youtube.com/watch?v=TPUDPhpCecA&feature=player_detailpage
- CBOE
  - http://www.youtube.com/watch?v=_UXomMnQK_T4&feature=player_detailpage
Focus on Ethics

The Ethics of Insider Trading

– Martha Stewart was convicted of conspiracy, obstruction, and making false statements to federal investigators and served 5 months in jail, 5 months of home confinement, 2 years of probation, and a $30,000 fine.

– Laws prohibiting insider trading were established in the United States in the 1930s. These laws are designed to ensure that all investors have access to relevant information on the same terms.

– However, many market participants believe that insider trading should be permitted.

– If efficiency is the goal of financial markets, is allowing or disallowing insider trading more unethical?

– Does allowing insider trading create an ethical dilemma for insiders?
The Financial Crisis: Financial Institutions and Real Estate Finance

• **Securitization** is the process of pooling mortgages or other types of loans and then selling claims or securities against that pool in a secondary market.

• **Mortgage-backed securities** represent claims on the cash flows generated by a pool of mortgages and can be purchased by individual investors, pension funds, mutual funds, or virtually any other investor.

• A primary risk associated with mortgage-back securities is that homeowners may not be able to, or may choose not to, repay their loans.
Regulation of Financial Institutions and Markets: Regulations Governing Financial Institutions

• The Glass-Steagall Act (1933) established the Federal Deposit Insurance Corporation (FDIC) which provides insurance for deposits at banks and monitors banks to ensure their safety and soundness.

• The Glass-Steagall Act also prohibited institutions that took deposits from engaging in activities such as securities underwriting and trading, thereby effectively separating commercial banks from investment banks.
Regulation of Financial Institutions and Markets: Regulations Governing Financial Markets

• The **Securities Act of 1933** regulates the sale of securities to the public via the primary market.
  – Requires sellers of new securities to provide extensive disclosures to the potential buyers of those securities.

• The **Securities Exchange Act of 1934** regulates the trading of securities such as stocks and bonds in the secondary market.
  – Created the **Securities Exchange Commission**, which is the primary government agency responsible for enforcing federal securities laws.
  – Requires ongoing disclosure by companies whose securities trade in secondary markets (e.g., 10-Q, 10-K).
  – Imposes limits on the extent to which “insiders” can trade in their firm’s securities.
Business Taxes

- Both individuals and businesses must pay taxes on income.
- The income of sole proprietorships and partnerships is taxed as the income of the individual owners, whereas corporate income is subject to corporate taxes.
- Both individuals and businesses can earn two types of income—ordinary income and capital gains income.
- Under current law, tax treatment of ordinary income and capital gains income change frequently due frequently changing tax laws.
## Table 2.1
Corporate Tax Rate Schedule

<table>
<thead>
<tr>
<th>Range of taxable income</th>
<th>Base tax</th>
<th>+</th>
<th>(Marginal rate × amount over base bracket)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 to $50,000</td>
<td>$0</td>
<td>+</td>
<td>(15% × amount over $50,000)</td>
</tr>
<tr>
<td>$50,000 to $75,000</td>
<td>7,500</td>
<td>+</td>
<td>(25% × amount over $75,000)</td>
</tr>
<tr>
<td>$75,000 to $100,000</td>
<td>13,750</td>
<td>+</td>
<td>(34% × amount over $100,000)</td>
</tr>
<tr>
<td>$100,000 to $335,000</td>
<td>22,250</td>
<td>+</td>
<td>(39% × amount over $335,000)</td>
</tr>
<tr>
<td>$335,000 to $10,000,000</td>
<td>113,900</td>
<td>+</td>
<td>(34% × amount over $10,000,000)</td>
</tr>
<tr>
<td>$10,000,000 to $15,000,000</td>
<td>3,400,000</td>
<td>+</td>
<td>(35% × amount over $15,000,000)</td>
</tr>
<tr>
<td>$15,000,000 to $18,333,333</td>
<td>5,150,000</td>
<td>+</td>
<td>(38% × amount over $18,333,333)</td>
</tr>
<tr>
<td>Over $18,333,333</td>
<td>6,416,667</td>
<td>+</td>
<td>(35% × amount over $18,333,333)</td>
</tr>
</tbody>
</table>
Ordinary income is earned through the sale of a firm’s goods or services and is taxed at the rates depicted in Table 2.1 on the previous slide.

**Example**

Weber Manufacturing Inc. has before-tax earnings of $250,000.

Tax = $22,500 + [0.39 \times ($250,000 – $100,000)]

Tax = $22,500 + (0.39 \times $150,000)

Tax = $22,500 + $58,500 = $80,750
Business Taxation: Marginal versus Average Tax Rates

- A firm’s **marginal tax rate** represents the rate at which additional income is taxed.
- The **average tax rate** is the firm’s taxes divided by taxable income.

**Example**

What are Webster Manufacturing’s marginal and average tax rates?

<table>
<thead>
<tr>
<th>Marginal Tax Rate</th>
<th>= 39%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Tax Rate</td>
<td>= (\frac{80,750}{250,000} = 32.3%)</td>
</tr>
</tbody>
</table>
Calculate corporate taxes

Taxable income = 78,000

\[13,750 + .34 \times 3,000 = 14,770\]

Average tax rate = \[\frac{14,770}{78,000} = 18.9\%\]

Marginal tax rate = 34%

Taxable income = 17,000,000

\[5,150,000 + .38 \times 2,000,000 = 5,910,000\]

Average tax rate = \[\frac{5,910,000}{17,000,000} = 34.7\%\]

Marginal tax rate = 38%
Business Taxation: Interest and Dividend Income

• For corporations only, 70% of all dividend income received from an investment in the stock of another corporation in which the firm has less than 20% ownership is excluded from taxation.

• This exclusion moderates the effect of double taxation, which occurs when after-tax corporate earnings are distributed as cash dividends to stockholders, who then must pay personal taxes on the dividend amount.

• Unlike dividend income, all interest income received is fully taxed.