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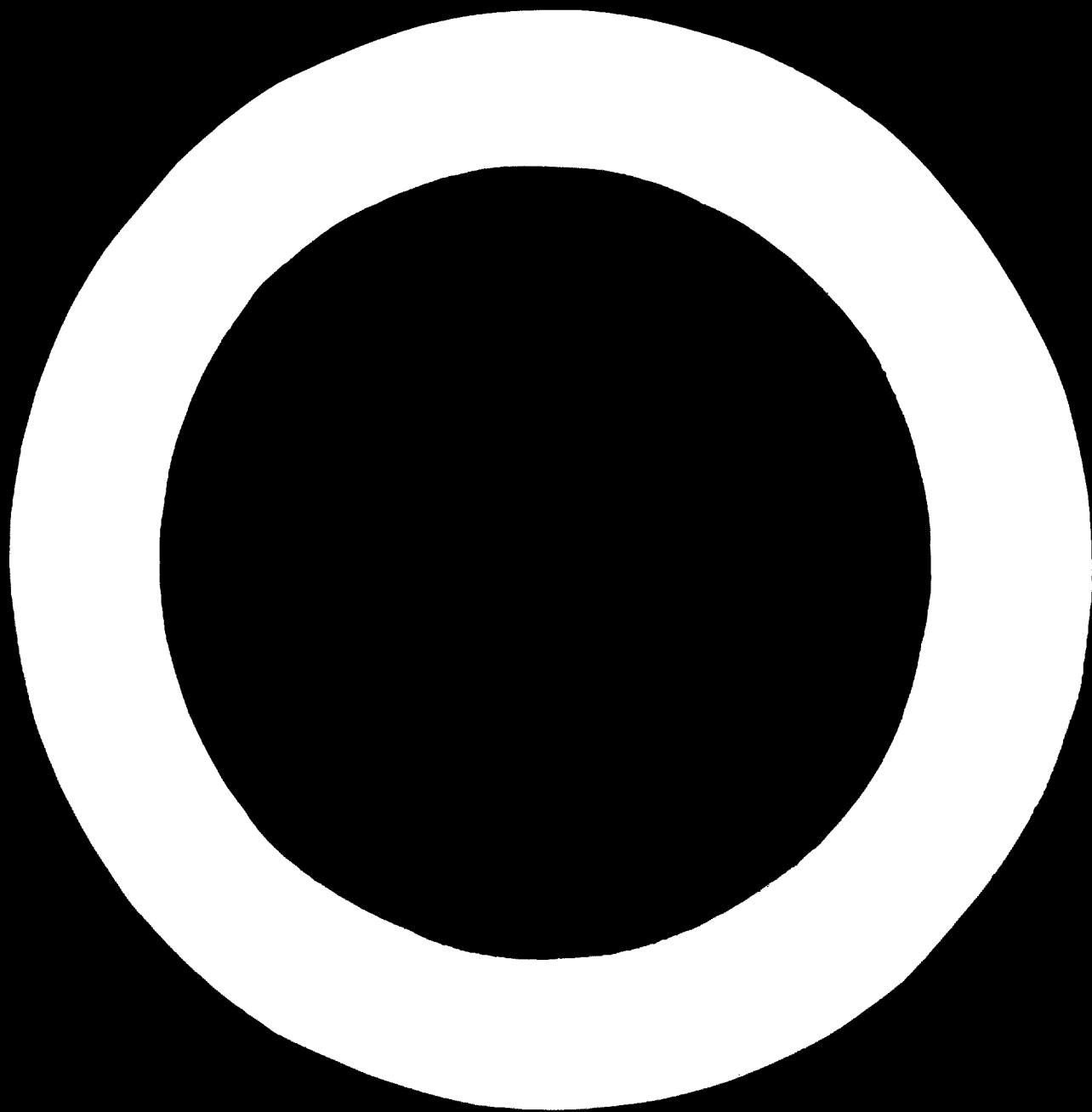
FINANCIAL INTERMEDIARIES IN THE CAPITAL MARKETS

by

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FINANCIAL INTERMEDIARIES IN THE CAPITAL MARKETS

NEW FUNDS SUPPLIED DIRECTLY TO THE CAPITAL MARKETS BY NON BANK FINANCIAL INTERMEDIARIES.

(IN BILLIONS OF \$, NEW MONEY SUPPLIED IN EACH 5 YEAR PERIOD NET OF INVESTMENT MATURITIES AND SALES.)

	<u>1947-51</u>	<u>1952-56</u>	<u>1957-61</u>	<u>1962-66</u>
LIFE INSURANCE COMPANIES	18.9	25.9	28.1	38.7
NON-INSURED PENSION FUNDS	4.9	10.4	17.3	23.5
SAVINGS AND LOAN ASSOCIATIONS	9.0	23.6	39.3	52.3
INVESTMENT BANKERS	0.3	1.5	2.3	0.4
COMMERCIAL FINANCE COMPANIES	4.7	8.3	7.5	18.8
MUTUAL FUNDS	1.1	2.8	6.0	8.2

THE FLOW OF FUNDS INTO THE CAPITAL MARKETS OF THE UNITED STATES HAS ALWAYS BEEN THE RESULT OF SAVING AND INVESTMENT. HOWEVER THE INSTITUTIONAL INTERMEDIARIES THROUGH WHICH THE FUNDS ARE CHanneled HAVE CHANGED DURING RECENT YEARS IN SIZE, STRUCTURE, AND OUTLOOK. INDUSTRY, TOO, HAS CHANGED TECHNOLOGICALLY, BUT ITS GROWTH IN TERMS OF REAL GROSS NATIONAL PRODUCT DEMANDS AN EVER-INCREASING NEED FOR PERMANENT CAPITAL. IT IS WITHIN THIS FRAMEWORK OF GROWTH, THEN, THAT THE CAPITAL REQUIREMENTS OF INDUSTRY CAN BE VIEWED IN THE RECENT PAST, THE PRESENT, AND THE IMMEDIATE FUTURE.

THE PRIMARY REASONS FOR WHICH INDUSTRY BORROWS ON A LONG-TERM BASIS, ARE TO FINANCE THE PURCHASE OF FIXED ASSETS, WORKING CAPITAL OF THE FIRMS, ACQUISITIONS, AND GENERAL CORPORATE PURPOSES. IN ADDITION TO THE CREDITORS OF INDUSTRY THERE ARE ALSO THE OWNERS, OR PURCHASERS OF CORPORATE STOCKS, WHO SUPPLY LONG TERM EQUITY FUNDS FOR GROWTH. TO OBTAIN A PERSPECTIVE REGARDING DEBT AND EQUITY FLOW, IT IS PERHAPS BEST TO EXAMINE THE MOST POWERFUL INTERMEDIARIES IN THE AMERICAN ECONOMY.

AS OF 1966, THE LARGEST SINGLE CONTRIBUTOR TO THE CAPITAL MARKETS, EXCLUDING COMMERCIAL BANKS, ARE THE NATION'S LIFE INSURANCE COMPANIES. AS OF YEAR-END 1966, THE COMPANIES' GROSS MONEY FLOW INTO THE CAPITAL MARKETS WAS APPROXIMATELY 33.1 BILLION DOLLARS. THIS FIGURE, COMPARED WITH NEW INVESTMENT ACQUISITIONS OF 35.4 BILLION IN 1965 AND 29.2 BILLION IN 1964, INDICATES A MODERATE BUT STEADY GROWTH IN THE LIFE INSURANCE INDUSTRY'S LONG TERM POSITION IN CAPITAL INVESTMENT.

A FURTHER STUDY OF THE ACQUISITIONS OF NEW INVESTMENTS BY LIFE INSURANCE COMPANIES FROM 1964 TO THE ESTIMATES OF 1966 INDICATES A MARKED PREFERENCE FOR INDUSTRIAL AND MISCELLANEOUS BONDS. THESE ISSUES ARE CREDIT-RATED BY INDEPENDENT AGENCIES AND SOLD AT PRICES DETERMINED PRIMARILY BY THE TRADING BOND MARKET. DEPENDING UPON THE CREDIT STATUS OF THE ISSUING COMPANY, ITS BONDS MAY REQUIRE SUPPORT BY A SINKING FUND PROVISION. THIS FORCES THE COMPANY TO SET ASIDE EACH YEAR A CERTAIN PERCENT OF THE BOND PRINCIPAL TO BE PAID TO THE HOLDER AT MATURITY. THE SECOND PREFERENCE OF LIFE INSURANCE COMPANIES IS THE MORTGAGE MARKET. THESE FLOWS OF MONEY ARE SECURED BY THE REAL PROPERTY WHICH THEY FINANCE. THE RISK IS USUALLY SMALL TO THE INSURANCE COMPANY, AND THE RETURN IS FIXED AT A SET RATE DEPENDING ON THE MORTGAGE MARKET IN GENERAL. CORPORATE STOCKS, PUBLIC UTILITY BONDS AND POLICY LOANS AGAINST CASH SURRENDER VALUE CONSTITUTE THE INDUSTRY'S LESSER INVESTMENT PREFERENCES. A CHART PUBLISHED BY THE LIFE INSURANCE ASSOCIATION OF AMERICA MAKES CLEAR THE ENTIRE SPECTRUM.

TABLE 3
ACQUISITIONS OF INVESTMENT, 1964 - 1966
ALL UNITED STATES LEGAL RESERVE
LIFE INSURANCE COMPANIES
(GROSS-NOT NET OF SALES AND MATURITIES)
(IN MILLIONS OF DOLLARS)

<u>INVESTMENT CLASS</u>	<u>1964</u>	<u>1965</u>
RAILROAD BONDS	\$ 103	\$ 111
PUBLIC UTILITY BONDS	940	768
INDUSTRIAL & MISC. BONDS	14,639	19,860
STOCKS	1,066	1,463
MORTGAGES	10,433	11,137
REAL ESTATE	488	448
POLICY LOANS	1,574	1,704
TOTAL	<u>\$29,243</u>	<u>\$35,489</u>

BECAUSE INSURANCE COMPANIES ARE IN EFFECT ACTING IN A FIDUCIARY CAPACITY, THEIR INVESTMENTS ARE LEGALLY LIMITED TO THE LOW-RISK, STEADY-RETURN TYPE. TERM LOANS TO PROVEN INDUSTRIES UNDER LEGAL AGREEMENT ARE ALSO MADE BY THE LIFE INSURANCE INDUSTRY. IN THESE CASES, THE INSURANCE COMPANY CAN AFFORD TO AGREE ON LONGER TERMS BECAUSE OF THE STABILITY OF ITS PREMIUM RECEIPTS. USUALLY, LONG-RANGE TERM LENDING TO AN INDUSTRIAL CONCERN OR A FINANCIAL COMPANY IS DONE ONLY WHEN GOOD ASSET TURNOVER AND A STEADY CASH FLOW ARE PROVEN CHARACTERISTICS OF THE COMPANY IN QUESTION. IN GENERAL, THEN IT MAY BE SAID THAT CAPITAL INVESTMENTS BY THE LIFE INSURANCE COMPANY HAVE THREE PROMINENT CHARACTERISTICS.

1. THEY ARE LONG-TERM (10-30 YEARS)
2. THEY ARE LOW RISK
3. THEY RETURN A LOW BUT STEADY YIELD

THE SECOND LARGEST INTERMEDIARY IN THE CAPITAL MARKETS AS OF YEAR-END 1966 WERE THE NON-INSURED PENSION FUNDS. PENSION FUNDS HOLD THE CONTRIBUTIONS OF LABOR AND MANAGEMENT FOR EMPLOYEE RETIREMENT BENEFITS. THESE FUNDS HAVE INVESTED MORE HEAVILY IN HIGHER RISK, HIGHER RETURN CAPITAL STOCKS AS A PERCENTAGE OF THEIR TOTAL PORTFOLIO THAN ANY OF THE OTHER INTERMEDIARIES. THE AMOUNT OF NEW MONEY INVESTED IN THE YEAR 1966 BY PENSION FUNDS WAS MORE THAN DOUBLE THE AMOUNT INVESTED IN 1950. STUDIES OF PERSONAL DISPOSABLE INCOME HAS INDICATED THAT THE MONEY POURED INTO PENSION FUNDS BY THE PUBLIC HAS NOT IMPORTANTLY SUBTRACTED FROM OTHER FORMS OF SAVING. ALMOST ALL THE MONEY ACCUMULATED BY THE PENSION FUNDS HAS BEEN CHanneLED INTO TWO DEPARTMENTS OF THE CAPITAL MARKETS: CORPORATE BONDS AND CORPORATE STOCKS.

SAVINGS BANKS WHICH USED TO BE SIGNIFICANT FACTORS IN THE CORPORATE BOND MARKET HAVE WITHDRAWN COMPLETELY IN FAVOR OF MORTGAGES; THE MUTUAL FUNDS HAVE WITHDRAWN SOMEWHAT FROM THE STOCK MARKET IN FAVOR OF OTHER INVESTMENT POSSIBILITIES SUCH AS CORPORATE AND MUNICIPAL BONDS. THESE FACTS POINT OUT DRAMATICALLY THE IMPORTANCE OF THE PENSION FUNDS IN TAKING UP TO SLACK WHICH COULD HAVE HAD A SEVERE DAMPENING EFFECT ON BUSINESS CONFIDENCE DURING THE PAST TWENTY YEARS.

PENSION FUNDS CLEARLY DOMINATE THE LONG-TERM TREND OF THE STOCK MARKET IN THE SENSE THAT THEY BUY 3 TO 4 TIMES AS MANY EQUITIES YEAR BY YEAR AS ANY OTHER FINANCIAL INTERMEDIARY. THE BUYING IS SO STEADY, HOWEVER, THAT UNLIKE MUTUAL FUNDS IT HAS LITTLE IMPACT ON SHORT-TERM MARKET PRICES. A CHART OF INVESTMENT PREFERENCES OF ALL THE PENSION FUNDS OF THE UNITED STATES AS OF DECEMBER 31, 1965 CLARIFIES THEIR CHOICES IN THE CAPITAL MARKETS.

S.E.C. SURVEY OF CORPORATE PENSION FUNDS

BOOK VALUE AT YEAR END (000,000)

	1965 AMOUNT
CASH & DEPOSITS	\$ 710
U.S. GOVERNMENT SECURITIES	2,410
CORPORATE BONDS	20,741
OWN COMPANY	(967)
OTHER COMPANIES	(19,774)
PREFERRED STOCKS	656
COMMON STOCKS	23,153
OWN COMPANY	(1,712)
OTHER COMPANIES	(21,441)
MORTGAGES	2,572
OTHER ASSETS	2,648
TOTAL ASSETS	<u>\$52,890</u>

IN LOOKING FORWARD TO THE NEXT FIVE YEARS, IT CAN BE SAFELY SAID THAT PENSION FUNDS WILL BE IMPORTANT BUYERS IN THE BONO MARKET AND MUCH MORE IMPORTANT IN THE STOCK MARKET. BUT THE INERTIA OF THEIR VAST MONEY FLOW IS SUCH THAT THEY ARE NOT APT TO CREATE PRICE SWINGS IN EITHER MARKET.

THE THIRD LARGEST FINANCIAL INTERMEDIARY IN THE CAPITAL MARKET IS THE SAVINGS AND LOAN ASSOCIATION. THESE ASSOCIATIONS ACCEPT THE MONEY OF SAVERS AND PAY A DIVIDEND WHICH IS USUALLY HIGHER THAN THAT PAID BY THE COMMERCIAL BANKS. IN TURN, DEPOSITS ARE INVESTED ALMOST EXCLUSIVELY IN REAL ESTATE MORTGAGES. FROM 1963 TO 1966, THE CAPITAL INVESTED IN LONG-TERM MARKETS BY THIS GROUP HAS BEEN STEADILY DIMINISHING DUE CHIEFLY TO A RUNOFF IN SAVINGS DEPOSITS. A CHART DEPICTING FUNDS SUPPLIED RECENTLY BY SAVINGS AND LOAN ASSOCIATIONS TO THE TOTAL CAPITAL MARKET DEMONSTRATES THE DECLINE.

(IN BILLIONS OF DOLLARS)

<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>
13.2	11.0	9.3	4.2

WITH MORTGAGES AS THEIR CHIEF INVESTMENT PREFERENCE, THE ASSOCIATIONS' DECLINE HAS HAD A DEFINITE IMPACT ON THE PRIVATE CONSTRUCTION INDUSTRY. ALTHOUGH THE FIVE YEAR OUTLOOK FOR BUILDING FUNDS IS NOT PROJECTED TO BE AS LARGE AS BEFORE THE VIETNAM CONFLICT, THERE IS STILL A NEED FOR \$83.5 BILLION FROM 1967 TO 1971. MANY CAPITAL MARKET ANALYSTS HAVE PREDICTED A LIBERALIZED LEGISLATION IN REGARD TO THE INVESTMENTS OF THE SAVINGS AND LOAN ASSOCIATIONS LINKED WITH A HIGHER INTEREST RATE CEILING TO BE PAID TO DEPOSITORS. NONETHELESS, EVEN IF THE ASSOCIATIONS SHOULD BE LEGALLY ALLOWED TO MAKE COMMERCIAL LOANS, THEIR DIRECT IMPACT ON INDUSTRIAL GROWTH IS NOT FORECASTED AS ANYTHING MORE THAN MINIMAL.

MOVING INTO THE RISK AREAS OF THE CAPITAL MARKETS, WE ENCOUNTER TWO UNIQUE AND VITAL INTERMEDIARIES; THE INVESTMENT BANKERS AND THE COMMERCIAL FINANCE COMPANIES. INVESTMENT BANKERS DO NOT VIEW THEIR FUNCTION AS ULTIMATE HOLDERS OF CORPORATE STOCKS AND BONDS. RATHER, THEY ARE ASTUTE UNDERWRITERS OF DEBT AND EQUITY ISSUES WHO RECEIVE A COMMISSION AND RESELL THE ISSUES TO THE PUBLIC AND OTHER INTERMEDIARIES. THE UNDERWRITING OF A HUGE CORPORATE BOND ISSUE IS AN ARDUOUS TASK AND REQUIRES PERFECT TIMING ON THE PART OF THE INVESTMENT BANKER. AFTER THE CORPORATION AGREES WITH THE INSTITUTION ON A MARKETABLE COUPON RATE, THE INVESTMENT BANKER FORWARDS THE PRINCIPAL AMOUNT TO THE COMPANY, TAKES ITS COMMISSION BY AN IMMEDIATE DISCOUNT, AND BEGINS MARKETING THE BONDS TO THE ULTIMATE HOLDER. IN ITS EQUITY ACTIVITIES, INVESTMENT BANKERS ARE QUITE OFTEN THE UNDERWRITERS OF LARGE COMMON AND PREFERRED ISSUES. HERE, THE BANKERS MAKE THEIR PROFIT ON PRICE APPRECIATION AND RESALE IN THE OPEN MARKET. BASICALLY, THE INVESTMENT BANKERS ARE THE LINK BETWEEN THE INDUSTRIAL ISSUERS AND THE ULTIMATE HOLDERS OF CORPORATE STOCKS AND BONDS.

ANOTHER INTERMEDIARY WHICH IS WILLING TO TAKE A HIGH DEGREE OF RISK FOR A HIGH RETURN IS THE COMMERCIAL FINANCE COMPANY. THIS GROUP OF CAPITAL INVESTORS LENDS AT A RATE WHICH IS HIGHER THAN THAT OF THE COMMERCIAL BANKS. MARGINAL FIRMS WHICH THE BANKING SYSTEM CONSIDERS TOO RISKY FOR THEIR FUNDS ARE THE CHIEF CLIENTS OF THESE LENDERS. BECAUSE OF THE RISKS THE FINANCE COMPANIES TAKE, THEIR RATE CHARGED IS USUALLY $1/2\%$ HIGHER PER UNIT PERCENT CHARGED BY THE COMMERCIAL BANKS. FOR INSTANCE, IF THE BANK PRIME RATE WERE 6 PERCENT, THE COMMERCIAL FINANCE COMPANIES WOULD LEND AT A PRIME OF 9%. AS AN INTERMEDIARY, THE COMMERCIAL FINANCE COMPANIES ARE NOT AT ALL LARGE IN RELATION TO OTHER CAPITAL MARKET INSTITUTIONS.

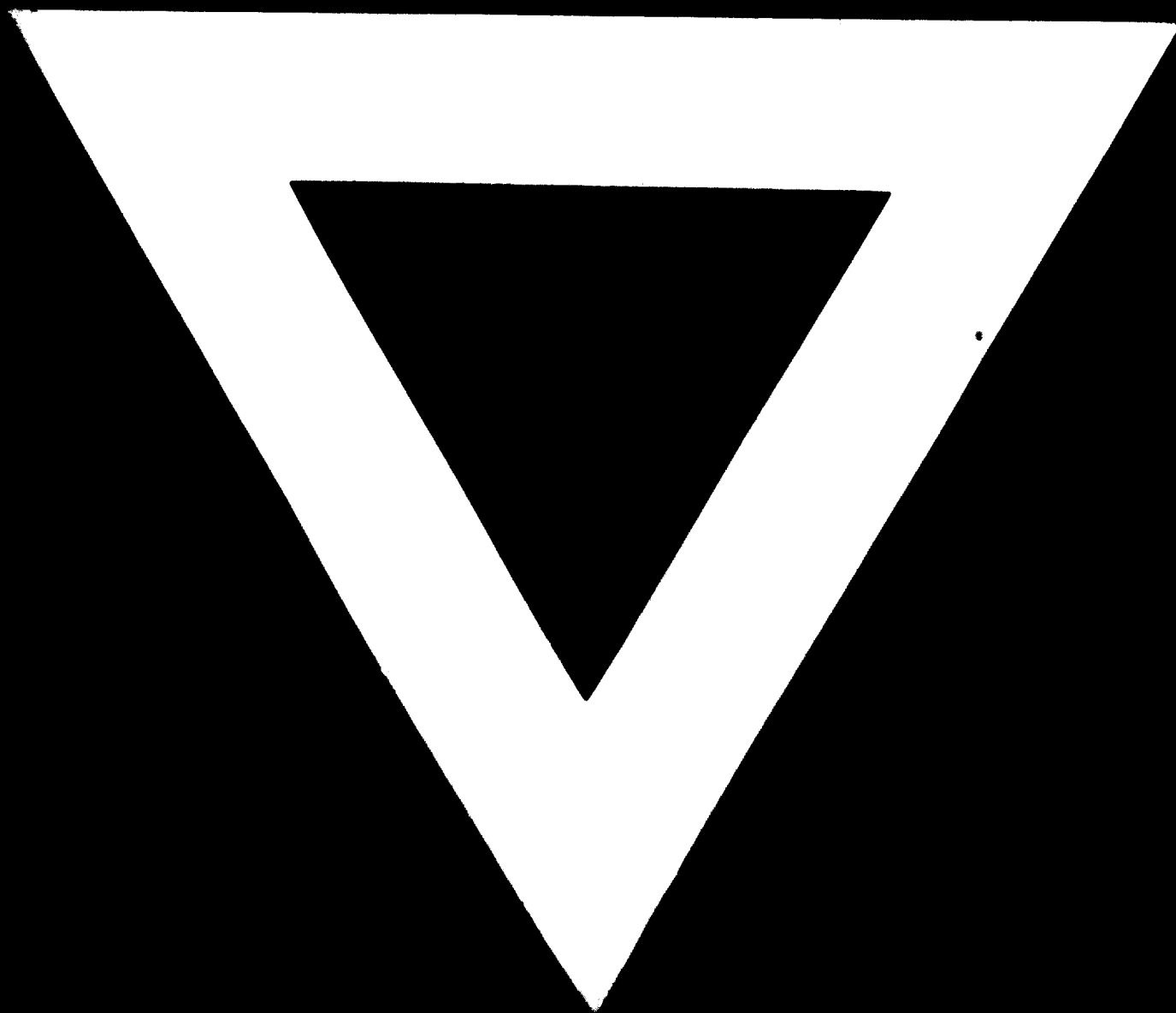
THE LAST FINANCIAL INTERMEDIARY OF CONSEQUENCE IS THE NEWEST, THE MUTUAL FUND. MUTUAL FUNDS INVEST THE PERIODIC PAYMENTS OF PRIVATE INDIVIDUALS IN COMMON AND PREFERRED CORPORATE STOCKS. BECAUSE OF THE DIFFERING OBJECTIVES OF INDIVIDUAL INVESTORS, THERE ARE FUNDS WITH DIFFERENT AIMS. INCOME FUNDS ARE POPULAR WITH RETIRED PEOPLE WHILE A GROWTH FUND WOULD BE MORE SUITABLE FOR A YOUNGER PERSON. BECAUSE OF VARYING NEEDS ARISING OUT OF THE FUNDS' INVESTOR PREFERENCE, THEIR GROWTH HAS BEEN SOMEWHAT ERRATIC.

BECAUSE OF SHIFTS IN INVESTED POSITION, THE FUNDS HAVE BEEN RESPONSIBLE FOR MANY SHORT-TERM SWINGS IN THE STOCK MARKET. THIS EFFECT MAY BE CONTRASTED WITH PENSION FUNDS' LONG TERM MARKET SUPPORT.

WHILE ALL THE FINANCIAL INTERMEDIARIES WILL BE CRITICALLY IMPORTANT TO INDUSTRY IN ITS DEMANDS FOR CAPITAL, MOST ECONOMISTS FEEL THAT A TIGHTNESS WILL DEVELOP DURING THE '67-71 PERIOD IN THE SUPPLY OF LONG-TERM MONEY. THREE PRINCIPAL REASONS FOR THE SHORTAGE ARE:

1. A POPULATION INCREASE IN OLDER AND YOUNGER GROUPS WHO TEND TO SPEND RATHER THAN SAVE.
2. A RELUCTANCE BY LENDERS TO EXTEND THEMSELVES UNLESS COMPENSATED FOR INFLATIONARY TRENDS.
3. A MORE RESTRICTIVE MONETARY CLIMATE BECAUSE OF A PERSISTENT BALANCE-OF-PAYMENTS PROBLEM.





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