FNCE 10001 - Finance 1

Lecture 1 – Introduction

Finance – The process of figuring out how to pay for something

Lecture 2 – Introduction to Financial Institutions

Functions of the Financial System

- Settle commercial transaction
- Arrange the flow of funds
- Transfer and manage risk
- Generate information to assist decision making
- Deal with incentive problems
- Pooling of Funds

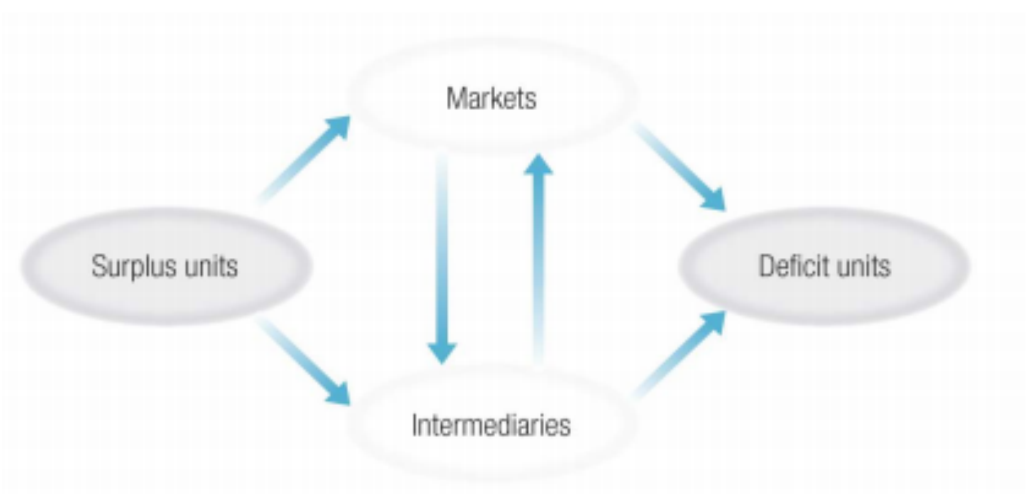
Who participates in the financial system?

Surplus Units – Suppliers of funds (lenders, shareholders, investors)

Deficit Units – Users of funds, people/business that uses some else's money (burrowers, credit card users)

You can be both at the same time.

The Financial system organizes the flow of funds between surplus and deficit units, funds can also transfer through intermediaries



Feature	Surplus units	Deficit units	
Return on funds	High as possible	Low as possible	
Length of contract	Flexible and short	Inflexible and long	maturity mismatch
Risk exposure	Varies, but many are risk averse	Risk taker	
Amount of funds	Usually small	Usually large	size mismatch

Connecting Surplus and Deficit Units = Intermediaries

- Intermediation is the flow of funds through institutions
- Called Authorized Deposit Taking Institutions (ADIs), most commonly banks
- How do intermediaries connect surplus and deficit units…CONTRACTS
    - ADIs raise funds from deposits
    - And use these funds to make loans

What is a contract?

- 'A promise for the breach of which the law gives a remedy'
- Contracts are commitments to undertake an event in the future
- Finance is principally built on promises

Types of Contracts

- Security = Financial contract that can be traded in a financial market
    - Asset Involved
    - Gives you quantity and unit
    - Has a set price
    - Has a set date
    - Has payment/settlement terms
    - Principally, you can trade financial contracts
- Two common types of securities
    - Debt and Equity

	Debt	Equity
Return (cost)	Agreed interest rate	Varies (dividend + capital gain)
Term	Finite	No terminal date
Ranking	Ahead of equity	Behind creditors
Risk to supplier of funds	Default and lower interest rates	Residual claim, so higher risk
Governance	Covenants and security	Appoints directors & management

Primary and Secondary Markets

Primary – Arranges for issue of new securities

Subsequent trading of existing securities occurs in the secondary market.

How do secondary markets assist primary markets

- Provide liquidity (the ability to cash out)
- Perform price discovery
- Develop the supply of investment funds

Risks in Finance

Risk – The chance of an outcome not being achieved

Types of risk

- Credit Risk: Possibility that borrower will not meet scheduled repayments
- Market risk: Possibility of unexpected movements in market i.e. interest rates, exchange rates, security prices
- Operational Risk – Failure of process or control
- Default Risk – Borrowers do not make loans repayments as agreed, this occurs when deficit units can pay back surplus units the 'interest; or return that is given to them to compensate for surplus units deferring their money
- Shocks

Problems in markets – Agency Problems

- When the agent doesn't do exactly what the principal wants to do with their money, this is called agency costs
- Agent – A person who acts on behalf of another
- Principal – A person who empowers another to act as their representative
- These problems arise when the agent acts in their own interest
- Think shareholders hire managers to run a business, investors use advisers

Problems in Markets – Moral Hazard

- Sometimes someone has all control over financial activity, but doesn't bear costs
- Arises when a contract changes incentives so one party may not act responsibly

More problems in markets – Information Asymmetry

- Parties do not have equal access to information i.e. burrowers who know they wont be able to pay back the loan
- Results in <u>adverse selection</u>
- How to reduce this risk?
    - Credit standards
    - Provide information to both parties
    - Rely on market forces