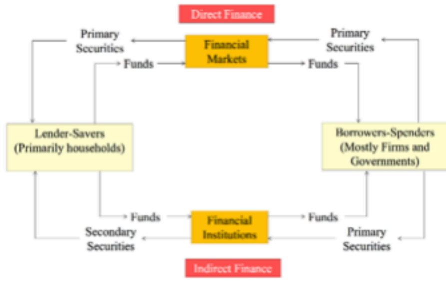
# Fins3630 study notes

## Week 1: Overview of Financial Institutions

### Goals and importance of financial system

- **Five parts:**
  - o <u>Money:</u> medium of exchange, unit of account, store of value
  - o <u>Financial instruments</u>: legal contracts used to transfer resources and risk between suppliers and users of funds
  - o <u>Financial market:</u> place to buy/ sell FI
  - o <u>Financial institutions:</u> institutions that provide service that facilitate flow of funds from savers to investors
  - o <u>Central bank:</u> monitor/ stabilise economy
- **Two roles:**
  - o Channel savings to investments
    - Better allocation of capital higher production/ efficiency
  - o Allow economic agents to ***share risks***




**<u>Direct Finance</u>:** Corporation borrow funds from households by selling securities (households face several costs and risk)

- *Information and monitoring cost:* information collection before transaction and monitoring after transaction
- *Liquidity cost:* long term nature of corporate debt and equity and lack of liquid secondary market to quickly sell securities
- *Price risk:* sale price of direct claim lower than purchase price of claim
  - o Household savers more concerned with preserving value of saving than earning high return
  - o Don't have scale to diversify price risk
- *Transaction cost:* because of small size of investment e.g. lawyer fee

**<u>Indirect Finance:</u>** FIs stand between lender/ borrowers

- Advantage of **economy of scale-** Pooling savings from large number of individual households *reducing transaction, info and monitoring cost.*
- FI buys primary securities by corporation and issues secondary securities (bank deposits) to household lenders
- **Asset transformation**- transformed unattractive primary securities to attractive secondary securities
  - o **Risk transformation**: FIs can diversify away some portfolio risk by *investing in many diff firms* (not perfectly positively correlated)
    - Allows FI to predict more accurately ER on asset portfolio

$$\sigma_p{}^2 = y_A{}^2\sigma_A{}^2 + 2y_A\, y_B\rho_{AB}\sigma_A\sigma_B + y_B{}^2\sigma_B{}^2$$

  - o **Liquidity transformation:** ability of FIs to *diversify source of funds* (predict more accurately expected daily withdrawals and set aside reserves to meet these withdrawals without liquidating long term investment at loss)