Intro to financial systems

Surplus unit – supplier of funds

Deficit unit – borrower of funds

Financing system organizes flow of funds from surplus to deficit units via intermediaries(bank) or financial markets

Differences of surplus and deficit units

- Maturity mismatch- mismatch in length of contract (surplus – flexible & short; deficit – inflexible and long)
- Size mismatch – mismatch in amount of funds (Surplus unit – small funds available; deficit – require large sum)
- Return – surplus (as high as possible) ; deficit (as low as possible)
- Risk – surplus (lower0; deficit (higher)

Intermediaries connect surplus and deficit units

- Eg. Deposit Taking Institutions (ADIs) – ie banks

ADIs – raises funds from deposits (deposit accounts and they pay interest to investors)

- Use funds to make loans (earn interest) – profit by interest rate spread & service fees

Intermediaries connect surplus & deficit units by contracts

- Contract = "a promise or a set of promises for the breach of which the law gives a remedy..."
- Promise = a commitment or an undertaking that some event will or will not occur in the future

Financial Contracts

- Security = a financial contract that can be traded in a financial market
    - Asst involved: commodity (has value eg. Gold), hard asset (eg. Property), financial assets(eg shares)
    - Quantity and unit (how many)
    - Price
    - Date
    - Payment/Settlement terms
- Transaction = arrangement between a buyer and a seller to exchange an asset or service for payment

Transaction and settlement can be different (eg pay by cheque – payment made and money received is different time)

Settlement = value (purchasing power) or title transfer to another party

Debt and equty are both forms of financial contracts

	Debt – form of loan agreement	Equity
Return (Cost)	Agreed interest rate	Varies (dividend + capital gain)
Term	Finite	No terminal date (ownership passes on to inheritor if owner dies)
Priority	Ahead of equity	Behond creditors
Risk to supplier of funds (if bankrupt)	Lower risk	Residual claim (higher risk)
Governance (Protect investments)	Convenants (terms & conditions) & secuity	Appoint directors & management

Primary market – arrange issue of new securities (surplus unit & deficit units meet ie Deficit unit going out to raise funds)

Secondary market – trading of existing securities (investor trade contracts). Eg stock market

- assists primary markets by – providing liquidity (investors more likely to buy in primary market if they are able to sell it in liquid active secondary market) ; perform price discovery; develop supply of investment funds

Risks in finance

- credit risk – borrower defaults on loan & does not pay back
- market risk – possibility of unexpected movement in the market (ie interest rates, exchange rates, security prices)
- operational risk – failure of process or control (eg CEO run away)
- shocks – unexpected eg hurricanes

Management of risks (there is always a cost to risk reduction)

- avoidance – eg opportunity cost – return foregone by passing up best choice
- acceptance/management – lender reduce credit by requiring mortgage
- transfer – insurance

Risk & Return relationship

- deficit units pay a return to compensate surplus units for deferring their use of funds & the risk they face (default risk)
- investors are risk averse (they have to be compensated to accept risk)
- return = interest gained

Problems In market

- agency problem – agent acts on their own benefit instead of the principal's
  - agent(acts on behalf of another) ; principal (person who employ's agent)
- moral hazard – type o agency problem. A person who has control over an activity but doesn't bear consequences/costs to it
  - eg. Insurance, bank loan approvals