FINS1612 Notes

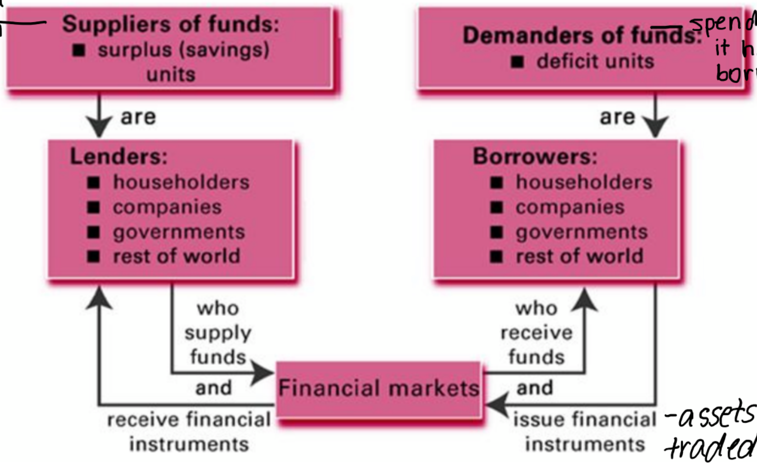
Week 1 Chapter 1 Finance Introduction

1. **Financial System**

- Consists of financial institutions, financial instruments and financial market which interact to facilitate flow of funds. – main function
- The Central bank (RBA) and <u>prudential supervisor</u> overseas the financial system. institutions adhere to min prudential standards.

Figure 1.1 Financial markets and flow of funds relationships

household, business or other entity that makes more than it spends



spend more than it has earned so has to borrow from surplus units

-assets that can be traded: cash, bonds

2. **Five types of financial institutions**

   i. <u>Depository financial institutions</u>
      a. Source funds from deposits lodged by savers
      b. Provide loans to borrowers in the household & business sectors

   ii. <u>Investment and merchant banks</u>
      a. Provide **off-balance sheet advisory services** (assets/liabilities that don't appear on b/s such as risk management, portfolio restructuring)
      b. Advise/assist a client to raise funds directly in the capital market (raise capital by detailing in shares, bonds & other long term investments)

Macquarie Group Limited

   iii. <u>Contractual savings institutions</u>
      a. In return for periodic cash receipts which provides them with large funds to invest, the institution will make payouts iff event in contract occurs.
      b. Insurance such as NRMA only gives $ for accidents. The rest they invest.

leads to financial claims & obligations

JPMorgan

iv. Finance companies

a. Raise funds by issuing financial securities such as commercial paper, medium term notes and bonds in the capital market.

b. Use funds to make loans and lease finance to household/business.

trusts created by lawyer
·individual
shows how a person's
$ should be managed
while alive or dead.

v. Unit trust

a. Formed by a trust deed where trustor gives trustee right to hold asset for benefit of third party, the beneficiary. —ie underage → receive possession when capable.

b. Attract funds by inviting public to purchase units in a trust. Fund managers invest funds in asset classes specified in the trust deed.

c. Types of trust: equity, property, fixed, mortgage.

3. Financial Assets

- Financial asset: anything entitled to future cash flows. 4 attributes:
  - **Return of yield**: financial compensation (interest) received from investment expressed as % of amount invested.
  - **Risk:** Probability actual return will vary from expectation
  - **Liquidity**: ability to sell asset within reasonable time and current cost
  - **Time-pattern of the cash flows:** maturity when cash flow expires.

).S entitles owners to share in the profits of company either through the receipt of dividends/cap gains.

- Financial instrument: issued by party raising funds, acknowledging a financial commitment and entitling holder to specified future cash flows. Grouped as:
  - Equity: ownership in any asset after subtracting debt. Such as:
    - Ordinary share: principal form of equity issued by org.
    - Preference shares: are hybrid, no voting rights but can be converted to ordinary shares.
    - Convertible notes: short term debt that converts into equity.
  - Debt: periodic interest payments and repayment of principal. Can be: securities can be bought/sold
    - Short term (money market instrument) <1 year or long term (capital market instrument) >1 year
    - Negotiable (it can be sold easily) or non-negotiable (e.g. term loan obtained from bank)
  - Derivatives: mainly used to manage price risk. 4 types:
    - Future contract
    - Forward contract
    - Option contract & Swap contract
  - Hybrid: incorporates both debt and equity i.e. preference share
- Financial security: financial asset that can be traded.

4. Financial Markets

stock in high demand during certain times of year

I. Matching principle

- Short term asset should be funded with short-term liabilities
  - E.g. Seasonal inventory needs to be funded by overdraft – bank balance goes below 0
- Longer-term assets should be funded with equity/longer-term liabilities
  - E.g. Equipment funded by debentures – debt instrument that is not secured by assets, only by reputation of issuer.

II. Primary & secondary markets

- Primary market issues new financial assets to raise funds
- Secondary market then buys/sells existing financial securities
  - Transfer of ownership from one saver to another
  - Provides liquidity which facilitates restructuring of portfolios of security owners

III. Direct and intermediated financial flow markets

	Advantages	Disadvantages
Direct Users of funds obtain finance directly from money & capital markets. Available only to corporations/govt that have good credit rating.	• Avoid intermediation costs • Increase range of securities/markets. • Allows diversifying funds.	• Matching of preferences • Liquidity of security • Search & transaction costs • Default risk
Intermediate Involves two separate contractual agreements where saver provide funds to intermediary who then provide funds to user of funds.	• Maturity transformation; range of terms to maturity. • Credit risk limited to intermediary.	• Economy of scale; savings gained by increased production, expertise, size.

IV. Wholesale and retail markets

Wholesale involves larger financial transactions ($10 000 +) with **direct financial flow** between institutional investors (fund manager) and borrowers. Retail involves smaller transactions with financial **intermediaries** by household and smaller business sectors.

V. Money markets vs Capital markets

Money markets are wholesale markets where short-term securities are issued and traded – debt market. Capital markets are same except have long-term securities – equity and debt market.

Financial market
- capital market
  - Primary " "
  - Secondary capital market
    - Domestic cap market
    - " "
- money market
  - primary " "
  - Secondary money market
    - " "
    - International $ market