Week 1: WHAT IS FINANCE?

Saving – change in a household's net worth
Investment – purchase of any asset
Depth, breadth, resilience

Role & Importance of the Financial System:

A financial market or system is a market in which people and entities can exchange financial securities, possessions, and other items. The financial system provides a means of transaction. Without the financial system, we may need to resort to trading items/bartering, or offering a return service. The financial system has three primary roles or components:

- ✓ Financial institutions: These include banks and non-banks financial institutions. These facilitate the transfer of funds by providing intermediation (indirect finance)
- ✓ Financial instruments: Financial instruments represent an entitlement to the holder to a specified set of future cash flows. In other words, financial instruments are tradable assets of any kind. Financial instruments can be traded via an exchange or over the counter. There are a variety of financial instruments which can be broadly classified according to the markets they are traded in, how they are issued (debt instrument-evidence of debt and promise of timely repayment, equity instrument-shares, derivatives-values derived from/dependent on the value of an underlying asset).
- ✓ Financial markets: These provide a forum for the creation and exchange of financial instruments. They facilitate efficient distribution of scarce funds between competing uses. The role of financial markets is to transfer funds from borrowers to lenders (funds flow from surplus units to deficit units) and to allocate funds between alternative uses.

Direct & Indirect Finance:

There are two main paths for funds to be transferred. One of these paths is direct financing. The other is indirect financing / intermediation.

Financial Intermediation (transformation) involves the transfer of funds between ultimate savers and ultimate borrowers via financial institutions, such as banks. During this process of transferring funds from surplus units to deficit units, these financial institutions act as intermediaries. Start with deposit. End with a loan. These are 2 separate assets.

An example of how intermediation works: Mary (saver/surplus unit) deposits $100 in her bank account and the bank on-lends those funds to a company (borrower/deficit unit).

- Intermediation allows borrowers and savers to transfer funds without having to match the other party's preferences. This provides many benefits to both parties, namely timeliness (not having to negotiate and find an individual with identical preferences) and subsequent cost-effectiveness (not penalized through fines or higher costs due to delays)
- **Asset transformation**: Borrowers and savers are offered a range of products
- **Maturity transformation**: Borrowers and savers are offered products with a range of terms of maturity
- **Liquidity transformation**: Liquidity refers to the ability to convert financial assets into cash. Borrowers and savers have different preferences for liquidity. Financial intermediation satisfies these different preferences by taking the intermediation role.
- **Credit risk diversification and transformation**: Savers' credit risk is limited to the intermediary, which has expertise and information

Direct Finance involves the transfer of funds between ultimate savers and ultimate borrowers without an intermediary. There is no transformation of financial claims in the process. It allows deficit units to issue financial claims on themselves and sell them for money directly to surplus units. These financial claims are bought and sold in financial markets. Surplus units and deficit units deal directly with each other. A broker or dealer may be involved in getting these parties together however no intermediation occurs.

An example of direct financing works: BHP may be issuing shares and raising capital directly from shareholders.

The disadvantages of direct finance indicate the important roles of intermediaries in our financial system.

- Through direct finance costs of intermediation can be avoided.
- Direct finance can increase access to a diverse range of markets.
- Direct finance can also provide greater flexibility in the range of securities that deficit units can issue for different financing needs.

o Matching of preferences can be difficult (borrowers and lenders may have different preferences in terms of amount, security etc…).

o Liquidity and marketability of a security is dependent upon the other party (will the buyer of a security be able to sell it easily? Is there a secondary market for that security?).

o Search and transaction costs may be high.

o Assessment of risk, especially default risk can be difficult (information may be limited.

Different types of Intermediaries:

In a financial context, commercial banks are the largest intermediary. The Australian banking sector is currently dominated by 4 banks: National Australia Bank (NAB), Westpac Banking Corporation, Commonwealth Bank of Australia and Australia & New Zealand Banking Group (ANZ).
In another context, insurance companies are intermediaries (for example, after a fire).
There are also Non-Bank Financial Corporations (NBFCs) act as intermediaries and provide many of the same services as commercial banks. Some of these groups include Building Societies, Credit Union, and Finance Companies.

Risks that Institutions Face:

"Risk" is a term often used to imply the downside risk, meaning the uncertainty of a return (of funds) and the potential for financial loss. Financial institutions are exposed to a variety of risks which include:

1) Credit risk: the risk of default on a debt that may arise from a borrower failing to make required payments or meet a contractual obligation.
2) Political risk: The risk that an investment's returns could suffer as a result of political changes or instability in a country. For example, tax and/or other laws may change which may negatively impact business.
    - Interest rate risk: the risk that an investment's value will change due to a change interest rates.

1. Liquidity risk: the risk that may arise from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss.

- Foreign exchange risk: chance that an investment's value will decrease due to changes in currency exchange rates.
- Reputational risk: A threat to the reputation of a business or entity. In addition to having good governance practices and transparency, companies (including financial institutions) also need to be socially responsible and environmentally conscious to avoid reputational risk.

Different types of Financial Markets:

Various financial markets play an important role in facilitating the transfer of funds of funds between surplus and deficit units. There are 2 types of financial markets:

1. **Primary markets** – markets where investors purchase financial securities from the original issuer. This might take place through an initial public offering (IPO) of shares to the public or through a private placement.