Reading in Banking and Finance

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READING IN FINANCE & BANKING

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WHAT IS FINANCE

Finance is the study of how and under what terms savings (money) are allocated between lenders and borrowers.

Finance is distinct from economics in that it addresses not only how resources are allocated but also under *what terms* and through *what channels*

Financial contracts or *securities* occur whenever funds are transferred from issuer to buyer.

In simple terms, finance is concerned with decisions about money, or more appropriately, cash flows.

Finance decisions deal with how money is raised and used by businesses, governments, and individuals.

To make sound financial decisions you must understand three general concepts: Everything else being equal ,

(1) more value is preferred to less;

(2) the sooner cash is received, the more valuable it is; and

(3) less risky assets are more valuable than (preferred to) riskier assets.

Firms that make decisions with these concepts in mind are able to provide better products to customers at lower prices, pay higher salaries to employees, and still provide greater returns to investors who put up the funds needed to form and operate the businesses.

In general, then, sound financial management contributes to the well-being of both individuals and the general population.

SOURCES OF FINANCE

Different ways a business can obtain money

SOURCES OF FINANCE

- Sources of finance can be classified into:
  - Internal sources (raised from within the organization)
  - External sources (raised from an outside source of the organization)

INTERNAL SOURCES

- There are five internal sources of finance:
  - Owner’s investment (start up or additional capital)
  - Retained profits
  - Sale of stock
  - Sale of fixed assets
  - Debt collection

INTERNAL SOURCES OWNER'S INVESTMENT

- This is money which comes from the owner/s own savings
- It may be in the form of start up capital - used when the business is setting up
- It may be in the form of additional capital – perhaps used for expansion
- This is a long-term source of finance

Advantages

- Doesn't have to be repaid
- No interest is payable

Disadvantages

- There is a limit to the amount an owner can invest

INTERNAL SOURCES RETAINED PROFITS

- This source of finance is only available for a business which has been trading for more than one year
- It is when the profits made are ploughed back into the business
- This is a medium or long-term source of finance

Advantages

- Doesn't have to be repaid
- No interest is payable

Disadvantages

- Not available to a new business
- Business may not make enough profit to plough back

INTERNAL SOURCES
SALE OF STOCK

- This money comes in from selling off unsold stock
- This is what happens in the January sales
- It is when the profits made are ploughed back into the business
- This is a short-term source of finance

Advantages

- Quick way of raising finance
- By selling off stock it reduces the costs associated with holding them

Disadvantages

- Business will have to take a reduced price for the stock

INTERNAL SOURCES
SALE OF FIXED ASSETS

- This money comes in from selling off fixed assets, such as:
  - a piece of machinery that is no longer needed
- Businesses do not always have surplus fixed assets which they can sell off
- There is also a limit to the number of fixed assets a firm can sell off
- This is a medium-term source of finance

Advantages

- Good way to raise finance from an asset that is no longer needed

Disadvantages

- Some businesses are unlikely to have surplus assets to sell
- Can be a slow method of raising finance

INTERNAL SOURCES DEBT COLLECTION

- A debtor is someone who owes a business money
- A business can raise finance by collecting the money owed to them (debts) from their debtors
- Not all businesses have debtors ie those who deal only in cash
- This is a short-term source of finance

Advantages

- No additional cost in getting this finance, it is part of the businesses' normal operations

Disadvantages

- There is a risk that debts owed can go bad and not be repaid

EXTERNAL SOURCES

- There are five internal sources of finance:
  - Bank Loan or Overdraft
  - Additional Partners
  - Share Issue
  - Leasing
  - Hire Purchase
  - Mortgage
  - Trade Credit
  - Government Grants

EXTERNAL SOURCES BANK LOAN

- This is money borrowed at an agreed rate of interest over a set period of time
- This is a medium or long-term source of finance

Advantages

- Set repayments are spread over a period of time which is good for budgeting

Disadvantages

- Can be expensive due to interest payments
- Bank may require security on the loan

EXTERNAL SOURCES BANK OVERDRAFT

- This is where the business is allowed to be overdrawn on its account
- This means they can still write cheques, even if they do not have enough money in the account
- This is a short-term source of finance

Advantages

- This is a good way to cover the period between money going out of and coming into a business
- If used in the short-term it is usually cheaper than a bank loan

Disadvantages

- Interest is repayable on the amount overdrawn
- Can be expensive if used over a longer period of time

EXTERNAL SOURCES ADDITIONAL PARTNERS

- This is sources of finance suitable for a partnership business
- The new partner/s can contribute extra capital

Advantages

- Doesn’t have to be repaid
- No interest is payable

Disadvantages

- Diluting control of the partnership
- Profits will be split more ways

EXTERNAL SOURCES SHARE ISSUE

- This is sources of finance suitable for a limited company
- Involves issuing more shares
- This is a long-term source of finance

Advantages

- Doesn’t have to be repaid
- No interest is payable

Disadvantages

- Profits will be paid out as dividends to more shareholders
- Ownership of the company could change hands

EXTERNAL SOURCES LEASING

- This method allows a business to obtain assets without the need to pay a large lump sum up front
- It is arranged through a finance company
- Leasing is like renting an asset
- It involves making set repayments
- This is a medium-term source of finance

Advantages

- Businesses can have the use of up to date equipment immediately
- Payments are spread over a period of time which is good for budgeting

Disadvantages

- Can be expensive
- The asset belongs to the finance company

EXTERNAL SOURCES HIRE PURCHASE

- This method allows a business to obtain assets without the need to pay a large lump sum up front
- Involves paying an initial deposit and regular payments for a set period of time
- The main difference between hire purchase and leasing is that with hire purchase after all repayments have been made the business owns the asset
- This is a medium-term source of finance

Advantages

- Businesses can have the use of up to date equipment immediately
- Payments are spread over a period of time which is good for budgeting
- Once all repayments are made the business will own the asset

Disadvantages

- This is an expensive method compared to buying with cash

EXTERNAL SOURCES MORTGAGE

- This is a loan secured on property
- Repaid in instalments over a period of time typically 25 years
- The business will own the property once the final payment has been made
- This is a long-term source of finance

Advantages

- Business has the use of the property
- Payments are spread over a period of time which is good for budgeting
- Once all repayments are made the business will own the asset

Disadvantages

- This is an expensive method compared to buying with cash
- If business does not keep up with repayments the property could be repossessed

EXTERNAL SOURCES GOVERNMENT GRANTS

- Some Government organisations offer grants to businesses, both established and new
- Usually certain conditions apply, such as where the business has to locate

Advantages

- Don't have to be repaid

Disadvantages

- Certain conditions may apply eg location
- Not all businesses may be eligible for a grant

FACTORS AFFECTING CHOICE OF SOURCE OF FINANCE

- The source of finance chosen will depend on a number of factors:
  - Purpose – what the finance is to be used for
  - Time Period – how long the finance will be needed for
  - Amount – how much money the business needs
  - Ownership and Size of the business

ELEMENTS OF FINANCE :

- ❖Financial Instruments
- ❖Financial Institutions
- ❖Dealers

CONCEPT OF FINANCIAL INSTRUMENTS

- Financial instruments refer to the documents that which represent financial claims on assets. It refers to a claim on to the repayment of a certain sum at the end of a specific period together with interest or dividend. Examples : bill of exchange, share, debenture, government bond, treasury bill…etc.
- **Financial Instruments*: The written legal obligation of one party to transfer something of value, usually money, to another party at some future date, under certain conditions*.**
  - The enforceability of the obligation is important.
  - Financial instruments *obligate one party* (person, company, or government) to transfer something to another party.
  - Financial instruments specify payment will be made at *some future date*.
  - Financial instruments *specify certain conditions* under which a payment will be made.

FEATURES OF FINANCIAL INSTRUMENTS

- They are easy transferable.
- They have a ready market
- They have posses liquidity.
- They can be used as a security for raising loans.
- Some of them have tax savings.
- They have specific maturity period.
- They facilitate future trading to cover risk.

TYPES OF FINANCIAL INSTRUMENTS

- **Debt instruments :**
- ✓ **Debt** simply is a sum owed by one person to another such as a firm, a government, or an individual.
- ✓ **Debt instruments** are documents used to raise loan (money). It is promise the payment of given sums to the lender.

- **Equity instruments :**
- **Equity** represents claims to shares in the net income and assets of a firm, and they do not have a maturity date or fixed return.

MAIN DIFFERENCE BETWEEN EQUITY AND DEBT

- In terms of economic rights, equity claims differ from debt instruments for several reasons.
- • First, firms are not contractually obliged to make periodic payments to equity holders: the payment of dividends is a discretionary decision of the firm.
- • Second, firms must pay all their debt holders before they make any payment to equity holders: therefore equity holders are residual claimants.
- As a result, equity claims are riskier than debt instruments. In addition to economic rights, equity claims confer ownership rights to equity holders. The presence of ownership rights is in contrast with bondholders, who have no ownership interest but are rather creditors of the firm.
- Ownership rights have two main implications.
- • First, equity holders can benefit from any increase in the income or asset value of the company. In the case of stock price increases (decreases) on the financial market, equity holders can obtain high capital gains (losses), whereas this is very unlikely by investing in bonds.
- • Second, equity holders have the right to vote for directors or on certain issues. The proportion of economic and ownership rights is different between common stocks and preferred stocks (as discussed below).

DEBT INSTRUMENTS (SHORT-TERM)

- **Short -Term Debt**: generally refers to debt with a maturity of one year or less. Some of the more common short-term debt instruments include the following

1- **Treasury Bills** : (T-bills) Discounted debt instruments issued by the government and have maturity less than one year.

2- **Repurchase Agreement (Repo):** An arrangement by which one firm sells some of its financial assets to another firm with a promise to repurchase the securities at a later date.

3- **Commercial Paper:** A discounted instrument that is a type of promissory note issued by large, financially sound firms.

4- **Banker' Acceptances :** An instrument issued by a bank that obligates the bank to pay a specified amount at some future date.

5- **Certificate of Deposit**: An interest-earning time deposit at a bank or other financial intermediary.

DEBT INSTRUMENTS (LONG-TERM)

1- Bond: A long-term contract under which a borrower agrees to make payments of interest and principal on specific dates to the bondholder.

2- Term Loan: A loan, generally obtained from a bank or insurance company, on which the borrower agrees to make a series of payments consisting of interest and principal.

3- Debenture: A secured loan raised by a company, usually with fixed interest rate and sometimes with a fixed redemption date.

EQUITY INSTRUMENTS

- **Common stock**: We usually refer to common stockholders as the "owners" of the firm because investors in common stock have certain rights and privileges generally associated with property ownership.

- **Preferred Stock**: A company share which carries no vote, but ranks before ordinary shares for dividends.

- Dividend : a payment of income by a company to its shareholders. Dividends are so called because a company is legally required to divide any sum available for distribution between its shareholders in proportion to the number of shares held.

FINANCIAL INSTITUTIONS:

- Definition
- Types

THE DEFINITION

- **Financial Institutions** : Firms that provide access to the financial markets, both to savers who wish to purchase financial instruments directly and to borrowers who want to issue them. They are also known as financial intermediaries.

- **Financial intermediaries** are economic agents who specialize in the activities of buying and selling (at the same time) financial contracts (loans and deposits) and securities (bonds and stocks).

- financial intermediaries Specialized financial firms that facilitate the indirect transfer of funds from savers to borrowers by offering savings instruments, such as certificates of deposit, and borrowing instruments, such as credit cards and mortgages.

THE ROLE OF FINANCIAL INSTITUTIONS

- To reduce transaction costs by specializing in the issuance of standardized securities.

- To reduce the information costs of screening and monitoring borrowers.

- They curb asymmetries, helping resources flow to most productive uses.

- To give savers ready access to their funds.

TYPES OF FINANCIAL INSTITUTIONS

1- **Depository institutions**: Financial institutions that accept deposits from individuals and provide loans.

- **Commercial banks**: financial institutions that accept deposits and use the funds to provide commercial and personal loans.
- **Savings institutions (or thrift institutions)**: financial institutions that accept deposits and provide mortgage and personal loans to individuals. **Thrift Institutions** Thrifts are financial institutions that cater (supply) to savers, especially individuals who have relatively small savings, and borrowers who need long-term loans to purchase houses. Thrifts were originally established because the services offered by commercial banks were designed for businesses rather than individuals, whose needs differed greatly. The two basic types of thrifts are savings and loan associations (S&Ls) and mutual savings banks.
- **Credit unions:** nonprofit depository institutions that serve members who have a common affiliation focus on Ethics: **A credit union** is a depository institution that is owned by its depositors, who are members of a common organization or association such as an occupation, a religious group, or a community. Credit unions operate as not-for-profit businesses and are managed by member depositors elected by other members.

2- Non-depository institutions. financial institutions that do not offer federally insured deposit accounts, but provide various other financial services.

- **Insurance companies**: accept premiums, which they invest, in return for promising compensation to policy holders under certain events. Insurance companies receive premiums from policy-holders, and promise to pay compensation to policy-holders if particular events occur

- **Pension funds** invest individual and company contributions in stocks, bonds, and real estate in order to provide payments to retired workers. Pension funds provide retirement income (in the form of annuities) to employees covered by a pension plan. They receive contributions from employers or employees and invest these amounts in corporate bonds and stocks. There are private pension funds and public pension funds.

- **Mutual-fund companies** : pool the resources of individuals and companies and invest them in portfolios. Mutual funds pool resources from many individuals and companies and invest these resources in diversified portfolios of bonds, stocks and money market instruments.

- **Finance companies** : make loans to individuals and corporations by providing consumer lending, business lending and mortgage financing. Some of their loans are similar to those provided by commercial banks. However, finance companies differ from commercial banks because they do not accept deposits. They raise funds by selling commercial paper (a short-term debt instrument) and by issuing stocks and bonds. Moreover, finance companies often lend to customers perceived as too risky by commercial banks.

DEALERS:

- Lender-Savers
- Households
- Business firms
- Government
- Foreigners

- Borrower-Spenders
- Business firms
- Government
- Households
- Foreigners

FINANCIAL SYSTEM

- Concept
- Functions
- Elements

CONCEPT OF FINANCIAL SYSTEM

- A financial system is a set of institutions, instruments, and market which promote savings and channels them to most efficient use. The system consists of individuals (savers), intermediaries (banks), markets, and users of savings (investors, corporations, government).

- Financial system comprises, a set of sub-systems of financial institutions, financial markets, financial instruments and services which help in formation of capital. It provides a mechanism by which savings are transformed into investment.

- The financial system is characterized by the presence of integrated, organized and regulated financial markets and institutions that meet the short term and long term financial need of both the household and corporation sector.

- The financial system is a set of institutional arrangement through which financial surpluses in the economy are mobilized from surplus units and transferred to deficit units (spenders). The institutional arrangements include all conditions and mechanisms governing the production, distribution, exchange and holding of financial assets or instruments of all kinds and the organization as well as the manner of operation of financial markets and institutions of all descriptions.

- The financial system should be distinguished from a payment system. The payment system is the set of institutional arrangements through which purchasing power is transferred from one transactor in exchange to another. Specialization in production necessities exchange. For efficient exchange, a common medium of exchange is necessary such as money. Thus, the payment system is organized around the use of money. Payments are made locally as well as across places, within the same country using one national money, or across countries involving the use of foreign monies. The payments are made in small, medium, or large amounts. An efficient payments system should permit all kinds of payments to be made highest convenience, quick, safety, and at very low costs to the economy and the transactors.

FUNCTIONS OF FINANCIAL SYSTEM

1) Provision of liquidity
2) Mobilizing of savings
3) Link between savers and investors
4) Selection of the projects to be financed and review the performance of such projects
5) Payment mechanism for exchange of good and services
6) Mechanism for the transfer of resources across geographic boundaries
7) Provide mechanism for managing and control risk
8) Promotes capital formation by bringing together the supply of savings and demand for investable funds
9) Lowering the cost of transactions and increase returns.
10) Reduced cost motivate people to save more
11) Provides information to the operators/ players in the market (individuals, government, and business corporation)

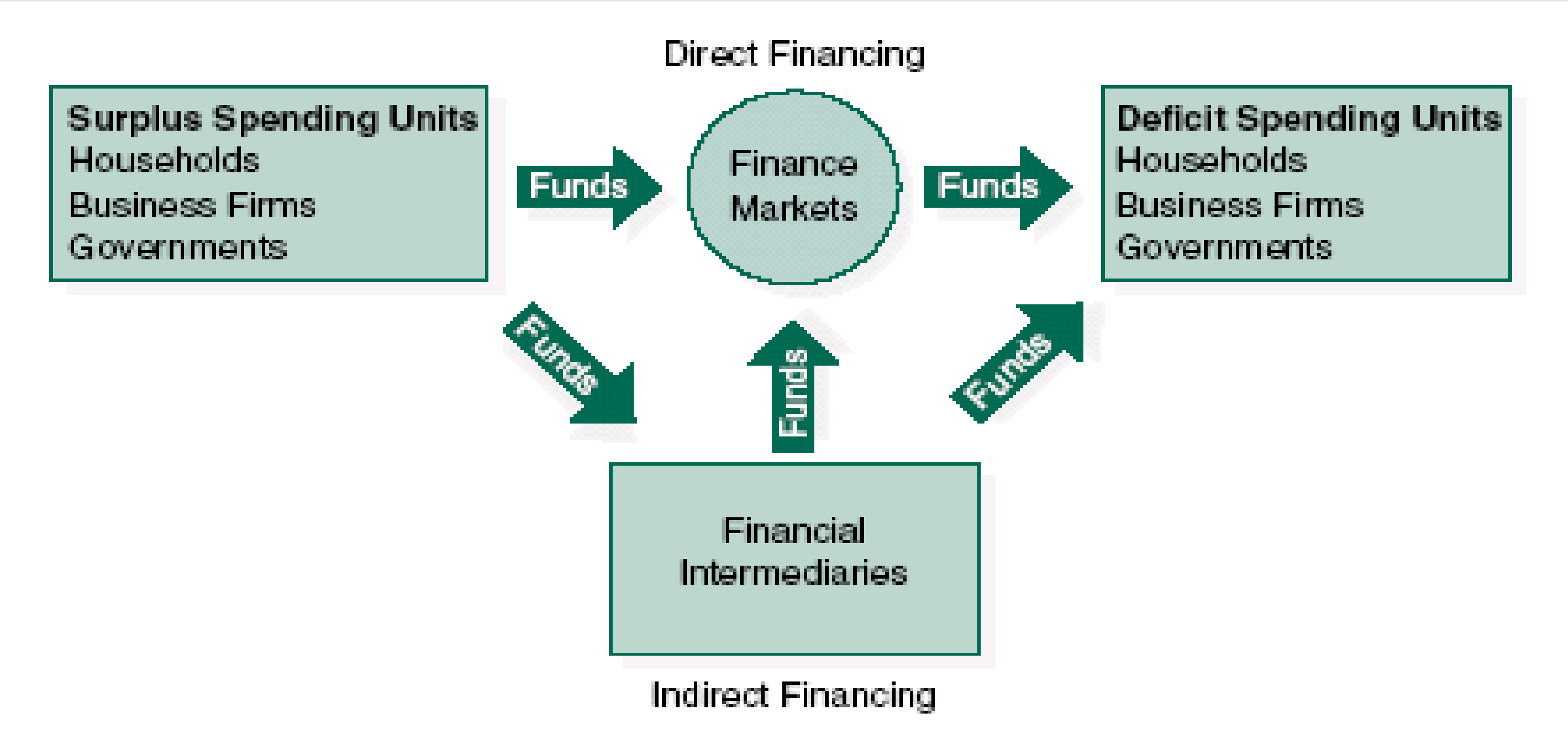
FUNDS CAN BE CHANNELED FROM SAVER TO BORROWER IN THREE WAYS:

- Direct intermediation (direct transfer from saver to borrower – a non-market transaction)

- Direct intermediation (a market-based transaction usually through a market intermediary such as a broker)

- Indirect claims through a financial intermediary (where the financial intermediary such as a bank offers deposit-taking services and ultimately lends those deposits out as mortgages or loans)

Transfer of Funds from Surplus to Deficit Spending Units



The role of the financial system—financial institutions and markets—is to facilitate the flow and efficient allocation of funds throughout the economy. The greater the flow of funds, the greater the accommodation of individuals' preferences for spending and saving. An efficient and sound financial system is a necessary condition to having a highly advanced economy like the one in the United States.

THE BASIC ELEMENTS OF A WELL-FUNCTIONING FINANCIAL SYSTEM:

- **(1) a strong legal and regulatory environment:** Since finance is based on contracts, strong legal and regulatory systems that produce and strictly enforce laws alone can protect the rights and interests of investors. Hence, a strong legal system is the most fundamental element of a sound financial system.

- **(2) stable money :** Stable money is an important constituent as it serves as a medium of exchange, a store of value (a reserve of future purchasing power), and a standard of value (unit of account) for all the goods and services we might wish to trade in. Large fluctuations and depreciation in the value of money lead to financial crises and impede the growth of the economy.

- **(3) sound public finances and public debt management:** Sound public finance includes setting and controlling public expenditure priorities and raising revenues adequate to fund them efficiently. Historically, these financing needs of the governments world over led to the creation of financial systems. Developed countries have sound public finances and public debt management practices, which result in the development of a good financial system.

(4) **a central bank**: A central bank supervises and regulates the operations of the banking system. It acts as a banker to the banks, banker to the government, manager of public debt and foreign exchange, and lender of the last resort. The monetary policy of the central bank influences the pace of economic growth. An autonomous central bank paves the way for the development of a sound financial system.

(5) **a sound banking system**: A good financial system must also have a variety of banks both with domestic and international operations together with an ability to withstand adverse shocks without failing. Banks are the core financial intermediaries in all countries. They perform diverse key functions such as operating the clearing and payments system, and the foreign exchange market. The banking system is the main fulcrum for transmitting the monetary policy actions. Banks also undertake credit risk analysis, assessing the expected risk and return on the projects. The financial soundness of the banking system depends on how effectively banks perform these diverse functions.

(6) **an information system**: Another foundational element is information. All the participants in a financial system require information. A sound financial system can develop only when proper disclosure practices and networking of information systems are adopted.

(7) **a well-functioning securities market**: Securities markets facilitate the issue and trading of securities, both equity and debt. Efficient securities markets promote economic growth by mobilising and deploying funds into productive uses, lowering the cost of capital for firms, enhancing liquidity, and attracting foreign investment. An efficient securities market strengthens market discipline by exerting corporate control through the threat of hostile takeovers for underperforming firms.

FINANCIAL MARKETS

- Concept of Financial Markets
- Importance of Financial Markets
- Types of Financial Markets

CONCEPT OF FINANCIAL MARKETS

- **Financial Markets** : In a general sense, the term financial market refers to a conceptual “mechanism” rather than a physical location or a specific type of organization or structure. We usually define the financial markets as a system that includes individuals and institutions, instruments, and procedures that bring together borrowers and savers, no matter the location.

IMPORTANCE OF FINANCIAL MARKETS

1- Channels funds from the surplus units (savers) to the deficit units (borrowers-spenders) .

2- Promotes economic efficiency by producing an efficient allocation of capital, which increases production.

3- Directly improve the well-being of consumers by allowing them to time purchases better.

TYPES OF FINANCIAL MARKETS

1- Primary Market

Markets in which various organizations raise funds by issuing new securities (Capital formation occurs)

- New security issues sold to initial buyers.

2- Secondary Market

Markets where financial assets that have previously been issued by various organizations are traded among investors. (No capital formation occurs).

- Securities previously issued are bought and sold.

1- Money Market:

The segments of the financial markets where the instruments that are traded have original maturities equal to one year or less such as Bankers' acceptances, Commercial Paper, and Treasury Bills.

- Short-Term (maturity <= 1 year)

2. Capital Market:

The segments of the financial markets where the instruments that are traded have original maturities greater than one year such as Bonds, Debentures, Common Stock, and Preferred Stock

- Long-Term (maturity > 1 year)