Chapter One
Overview of the Financial System

Asamnew T

Department of Accounting and Finance,
Addis Ababa University

Chapter Objectives

- Understanding the role of financial system in the economy
- Understanding financial assets: its characteristics and roles
- Understanding what a financial market is, its classifications, its actors
- Understanding function of financial intermediaries:
  - Lending and borrowing in the financial system

Financial System

- *What is a financial system?*
- An economic arrangement wherein financial institutions facilitate the transfer of funds and assets between borrowers, lenders, and investors.

Financial System

- The financial system has six parts, each of which plays a fundamental role in our economy.
  - Those parts are:
    - money,
    - financial instruments,
    - financial markets,
    - financial institutions,
    - government regulatory agencies, and
    - central banks.

Financial System…

- We use money to pay for our purchases and to store our wealth.
- We use financial instruments, to transfer resources from savers to investors and to transfer risk to those who are best equipped to bear it.
  - Stocks, mortgages, and insurance policies are examples of financial instruments.
- financial markets allows us to buy and sell financial instruments quickly and cheaply

Financial System…

- Financial institutions provide a myriad of services, including access to the financial markets and collection of information about prospective borrowers to ensure they are creditworthy.
- Government regulatory agencies are responsible for making sure that the elements of the financial system—including its instruments, markets, and institutions—operate in a safe and reliable manner.
- central banks monitor and stabilize the economy.
  - National bank of Ethiopia is our central bank

Core Functions OF A Financial System

1. The investment chain
2. Risk Management
3. Payment systems
4. Providing information

1. The investment chain

- Through the investment chain, savers and borrowers are brought together.
- Savers provide financing to businesses,
  - and businesses that wish to grow offer opportunities for savers to take part in the growth and resulting potential returns.
- The efficiency of this chain is critical to allocating what would otherwise be uninvested capital to businesses

  ....that can use it to grow their enterprises

1. The investment chain…..

- Pooling resources and subdividing shares
  - Financial systems enable multiple investors to contribute to projects that no one of them alone could afford.
- Transferring resources across time and space.
  - Firms in one industry, or in one location, may seek to invest surplus funds in other industries or at other locations.

2. Managing Risk

- Financial systems provide ways for investors to exchange, and thereby to control, risks.
  - For example,
    - insurance enables the pooling of risks,
    - hedging enables the transfer of risk to speculators,
    - diversification exploits low correlations that may exist among risky projects

3. Payment systems

- Financial systems provide mechanisms that facilitate exchanges of goods and services, as well as assets,
  - followed by settlement, transferring ownership in return for the agreed remuneration.
- It is an essential requirement for commercial activities to take place and for participation in international trade and investment.

4. Providing information

- One of the most prominent friction in the financial market is asymmetric information
- Financial markets, institutions and intermediaries produce useful information of potential borrowers to investors.
- Financial systems enable price discovery
  - – that is, for those who wish to trade to observe the prices (rates of exchange) at which agreements can be made.
  - – other information, for example about expectations of future asset price volatility, can be inferred from market prices.

Financial Assets

- An asset, broadly speaking, is any possession that has value in an exchange.
- Assets can be classified as tangible or intangible.
  - A tangible asset is one whose value depends on particular physical properties—examples are buildings, land, or machinery.
  - Intangible assets, by contrast, represent legal claims to some future benefit.
    - Their value bears no relation to the form, physical or otherwise, in which these claims are recorded.
    - Financial assets are intangible assets.
      - For financial assets, the typical benefit or value is a claim to future cash.

Real Assets Vs Financial Assets

Real Assets:

- are assets used in the process of production in the economy i.e., items such as factories, machinery patents, human capital, knowledge ,
.

Financial assets:

- are claims to the output of the production process. In other words, they are **legal contract** representing the **right to receive future financial benefits under a stated set of conditions**. E.g.

equity shares, bonds (corporate/government) deposit with banks, mutual fund shares, insurance policies, and derivative instruments

Financial Assets…

- The claim that the holder of a financial asset has may be either a fixed dollar amount or a varying, or residual, amount.
  - In the former case, the financial asset is referred to as a ***debt instrument***.
  - ***An equity instrument*** (also called a residual claim) obligates the issuer of the financial asset to pay the holder an amount based on earnings, if any, after holders of debt instruments have been paid.
  - Some securities fall into both categories….Preferred stock
  - Both debt and preferred stock that pay fixed dollar amounts are called fixed-income instruments.

The Price of a Financial Asset and Risk

- A basic economic principle is that the price of any financial asset is equal to the present value of its expected cash flow, even if the cash flow is not known with certainty.
  - By cash flow, we mean the stream of cash payments over time.

Financial Assets versus Tangible Assets

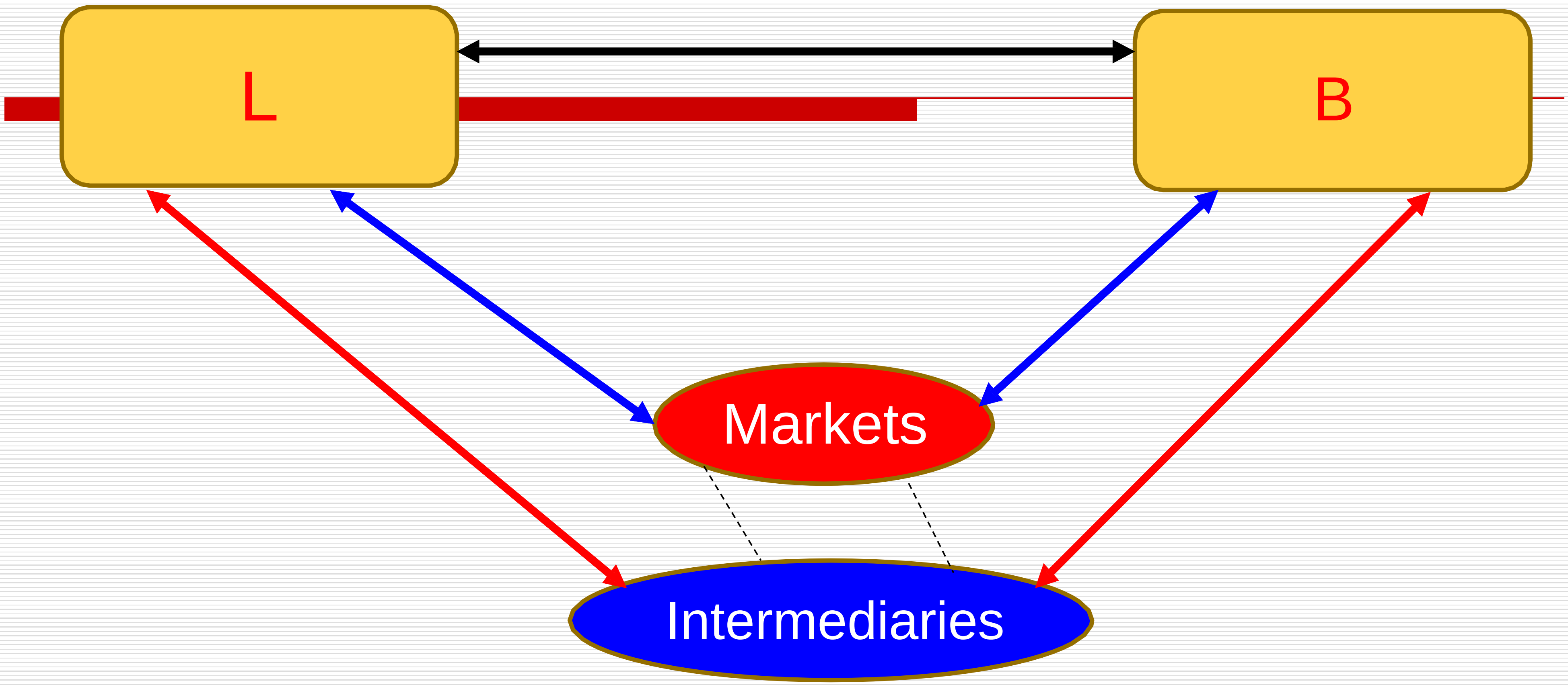
- Both are expected to generate future cash flow for their owner
- Financial assets and tangible assets are linked.
  - Ownership of tangible assets is financed by the issuance of some type of financial asset—either debt instruments or equity instruments
  - Ultimately, the cash flow for a financial asset is generated by some tangible asset.

PROPERTIES OF FINANCIAL ASSETS

- Moneyness
- Divisibility and Denomination
- reversibility,
- cash flow,
- term to maturity,
- convertibility,
- currency,
- liquidity,
- return predictability, and
- complexity

Financial Systems - Approaches

- Faced with end users desire (lend or borrow), there are three approaches:
- First, they may decide to deal directly with one another.
- Second, they may decide to deal via markets
- Third, they may decide to deal via intermediaries.


L
B
Markets
Intermediaries

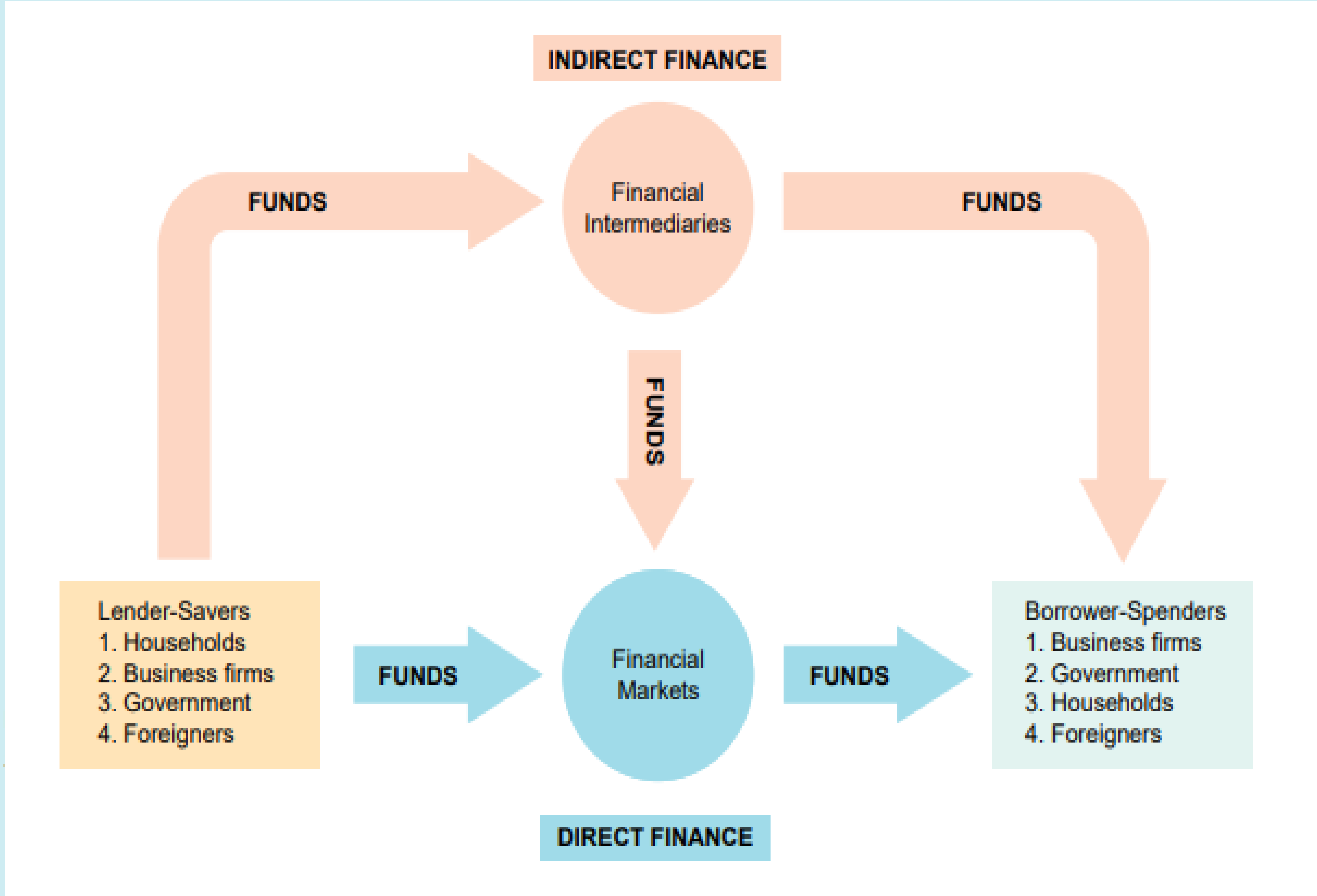


FIGURE 1 Flows of Funds Through the Financial System

Financial Markets

- In a market economy, the allocation of economic resources is driven by the outcome of many private decisions
  - Prices are signals that direct economic resources to their best use

Financial Markets…

- Two types of markets in an economy:
  1. The market for products (manufactured goods and services)
  2. The market for factors of production(labor and capital)
- Our focus is one part of the factor market, the market for financial assets……financial market

Financial Markets….

- A financial market is a market where financial assets are exchanged (i.e.» traded).
- Financial markets are markets in which funds are transferred from people and firms who have an excess of available funds to people and firms who have a need of funds.

Financial Markets…

- Financial markets, such as bond and stock markets, are crucial in an economy.
- These markets channel funds from savers to investors, thereby promoting economic efficiency.
- Well functioning financial markets, such as the bond market, stock market, and foreign exchange market, are key factors in producing high economic growth.

Financial Markets…

- Debt markets, or bond markets, allow governments, corporations, and individuals to borrow to finance activities.
- In this market, borrowers issue a security, called a bond, that promises the timely payment of interest and principal over some specific time horizon.
- The interest rate is the cost of borrowing.
- There are many different types of market interest rates, including mortgage rates, car loan rates, credit card rates, etc.

Financial Markets…

- The stock market is the market where common stock (or just stock), representing ownership in a company, are traded.
- Companies initially sell stock (in the primary market) to raise money. But after that, the stock is traded among investors (secondary market).
- The foreign exchange market is where international currencies trade and exchange rates are set.
- Foreign exchange (FX) markets are the largest of all financial markets, with average daily turnover in excess of US$5 trillion.

Financial Markets…

- Exercise: Of all the active markets, the stock market receives the most attention from the media. Why?

Functions of Financial Market

- Financial markets provide the following three major economic functions:
  - *Price discovery*
  - *Liquidity*
  - *Reduced transaction costs*
- *Price discovery*:
- Since the interactions of buyers and sellers in a Financial market determine the price of the traded asset, they determine the required return that participants in a financial market demand in order to buy a financial instrument.

Functions of Financial Market

- *Liquidity*:
- *Liquidity* is an appealing feature when circumstances arise that either force or motivate an investor to sell a financial instrument.
- Otherwise, an investor would be compelled to hold on a financial instrument until either conditions arise that allow for the disposal of the financial instrument or the issuer is contractually obligated to pay it off.

  For a debt instrument, that is when it matures, whereas for an equity instrument that is until the company is either voluntarily or involuntarily liquidated.

Functions of Financial Market

- *Liquidity*:
- *All financial markets provide some form of liquidity. However, the degree of liquidity is one of the factors that characterize different financial markets.*
- *The more actively that instruments trade in the market, the greater their liquidity. Moreover, the lower the market's trading costs, the greater trading volumes are likely to be.*
- *Thus a market in which it is cheap and easy to find counterparties is also likely to be a market in which the assets exchanged are relatively liquid*

Functions of Financial Market

***Reduced Transaction Costs*:**

- This is performed when Financial Market participants are charged and /or bear the costs of trading a financial instruments.

Functions of Financial Market

- In general, there are three classes of costs: *search and information costs, contracting and monitoring costs, and costs of incentive problems*.
- *Search and information costs:*
- *Search costs* fall into *two* categories: *explicit costs* and *implicit costs*. Explicit costs include expenses that may be needed to advertise one's intention to sell or purchase a financial instrument; implicit costs include the value of time spent in locating a counterparty to the transaction. *The presence of some form of organized financial market reduces search costs.*
- *Information costs* are costs associated with assessing a financial instrument's investment attributes. In a price efficient market, prices reflect the aggregate information collected by all market participants.

Functions of Financial Market

- *Cost of contracting and monitoring:*
- These costs are related to the costs necessary to resolve information asymmetry problems, when the two parties entering into the trs possesses limited information on each other and seek to ensure that the trs obligations are fulfilled.

- *Costs of incentive problems:*
- These are costs incurred when there are problems related to conflict of interest between buyers and sellers having different incentives for the trs involving financial assets.

Classification of Financial Markets

- There are many ways to classify financial markets.

CLASSIFICATION BY NATURE OF CLAIM:

Debt market

Equity market

CLASSIFICATION BY MATURITY OF CLAIM:

Money market

Capital market

CLASSIFICATION BY SEASONING OF CLAIM:

Primary market

Secondary market

CLASSIFICATION BY IMMEDIATE DELIVERY OR FUTURE DELIVERY:

Cash or spot market

Derivative market

CLASSIFICATION BY ORGANIZATIONAL STRUCTURE:

Exchange market

Over-the-counter market

Financial Intermediaries

- Instead of savers lending/investing directly with borrowers, a financial intermediary (such as a bank) plays as the middleman:
  - The intermediary obtains funds from savers
  - The intermediary then makes loans/investments with borrowers
- This process, called financial intermediation, is actually the primary means of moving funds from lenders to borrowers.
- More important source of finance than securities markets (such as stocks).

Financial Intermediaries…

- Financial intermediary needed because of transactions costs, risk sharing, and asymmetric information

1. Transactions Costs
   - Financial intermediaries make profits by reducing transactions costs.
   - Reduce transactions costs by developing expertise and taking advantage of economies of scale.

Financial Intermediaries…

2. Risk Sharing

- Financial Intermediaries low transaction costs allow them to reduce the exposure of investors to risk, through a process known as risk sharing.
- Financial Intermediaries create and sell assets with lesser risk to one party in order to buy assets with greater risk from another party.
  - This process is referred to as asset transformation, because in a sense risky assets are turned into safer assets for investors.

Financial Intermediaries…

- Financial intermediaries also help by providing the means for individuals and businesses to diversify their asset holdings.
- Low transaction costs allow them to buy a range of assets, pool them, and then sell rights to the diversified pool to individuals.

Financial Intermediaries…

3. Asymmetric Information

- Another reason Financial intermediaries exist is to reduce the impact of asymmetric information.
- One party lacks crucial information about another party, impacting decision-making.
- We usually discuss this problem along two fronts: adverse selection and moral hazard.

Financial Intermediaries…

- Adverse Selection
  - Before transaction occurs
  - Potential borrowers most likely to produce adverse outcome are ones most likely to seek a loan
  - Similar problems occur with insurance where unhealthy people want their known medical problems covered

Financial Intermediaries…

- Moral Hazard
  - After transaction occurs
  - Hazard that borrower has incentives to engage in undesirable (immoral) activities making it more likely that won’t pay loan back
  - Again, with insurance, people may engage in risky activities only after being insured
    - Another view is a conflict of interest

Financial Intermediaries…

- Financial intermediaries reduce adverse selection and moral hazard problems, enabling them to make profits.
- Because of their expertise in screening and monitoring, they minimize their losses, earning a higher return on lending and paying higher yields to savers.

Types of Financial Intermediaries

TABLE 2.1 Primary Assets and Liabilities of Financial Intermediaries

Type of Intermediary	Primary Liabilities (Sources of Funds)	Primary Assets (Uses of Funds)
Depository institutions (banks)		
Commercial banks	Deposits	Business and consumer loans, mortgages, U.S. government securities, and municipal bonds
Savings and loan associations	Deposits	Mortgages
Mutual savings banks	Deposits	Mortgages
Credit unions	Deposits	Consumer loans
Contractual savings institutions		
Life insurance companies	Premiums from policies	Corporate bonds and mortgages
Fire and casualty insurance companies	Premiums from policies	Municipal bonds, corporate bonds and stock, U.S. government securities
Pension funds, government retirement funds	Employer and employee contributions	Corporate bonds and stock
Investment intermediaries		
Finance companies	Commercial paper, stocks, bonds	Consumer and business loans
Mutual funds	Shares	Stocks, bonds
Money market mutual funds	Shares	Money market instruments

Source: Federal Reserve Flow of Funds Accounts: www.federalreserve.gov/releases/Z1/.