Key fundamentals on Financial Assets, Financial markets and Financial Intermediaries

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FIN201: Key fundamentals on Financial Assets, Financial markets and Financial Intermediaries

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Financial system

Definition:

- **The financial system** plays the key role in the economy by stimulating economic growth, influencing economic performance of the actors, affecting economic welfare. This is achieved by financial infrastructure, in which entities with funds allocate those funds to those who have potentially more productive ways to invest those funds.
- A financial system **makes it possible** a more efficient transfer of funds.

Financial system

- According to the **structural approach,** the financial system of an economy consists of three main components:

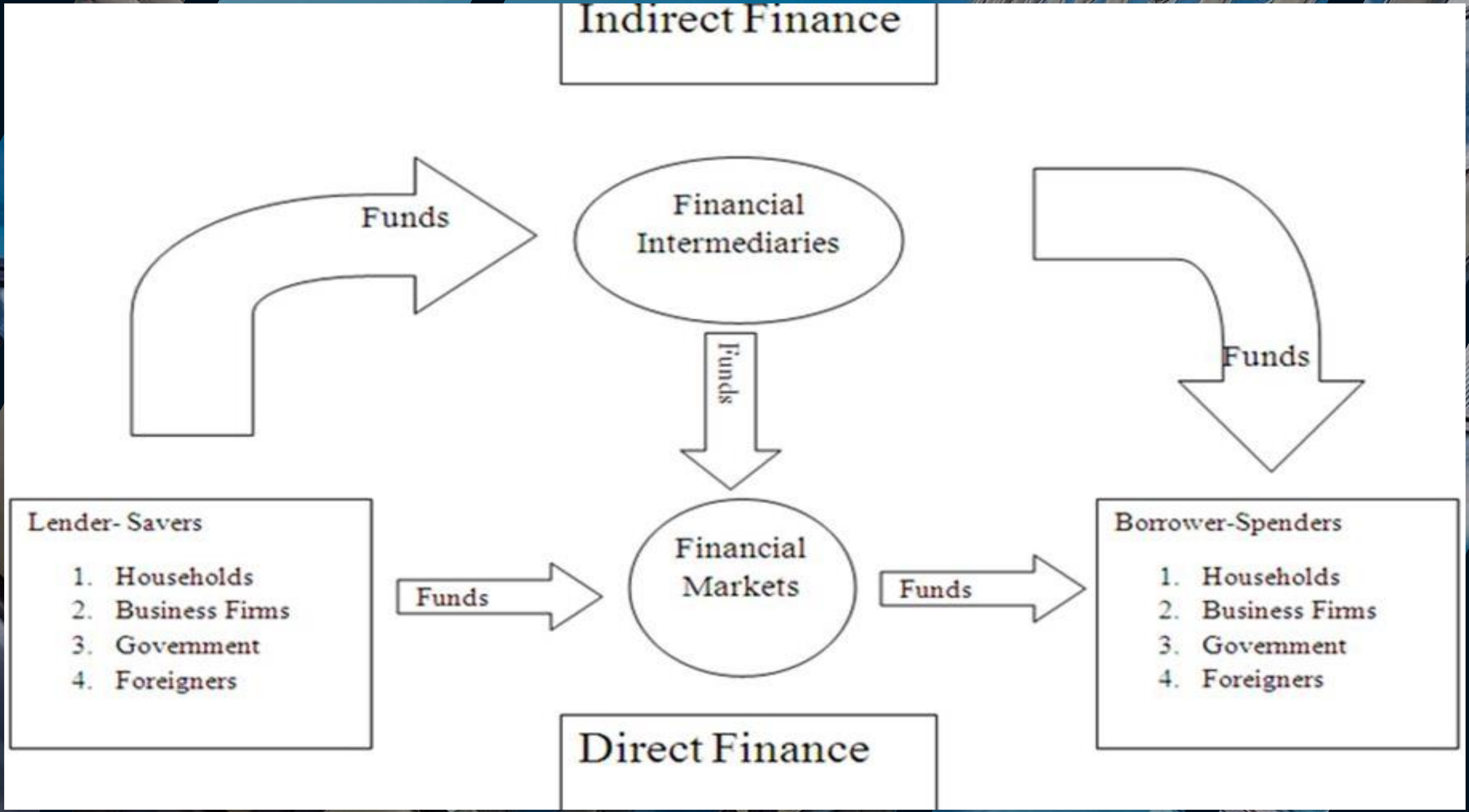
1) financial markets;

2) financial intermediaries (institutions);

3) financial regulators.

- Each of the components plays a specific role in the economy.
- According to the **functional approach, financial markets** facilitate the flow of funds in order to finance investments by corporations, governments and individuals.
- **Financial institutions** are the key players in the financial markets as they perform the function of intermediation and thus determine the flow of funds.
- The **financial regulators** perform the role of monitoring and regulating the participants in the financial system.

The structure of financial system (flow of funds)



Financial assets

Definition:

- An **asset** is any resource that is expected to provide future benefits, and thus possesses economic value.
- Assets are divided into two categories: tangible assets with physical properties and intangible assets. An *intangible asset* represents a legal claim to some future economic benefits. The value of an intangible asset bears no relation to the form, physical or otherwise, in which the claims are recorded.

Types of assets

- Tangible Assets
  - Value is based on physical properties
  - Examples include buildings, land, machinery
- Intangible Assets
  - Claim to future income
  - Examples include various types of financial assets

Financial assets

- **Financial assets**, often called **financial instruments**, are intangible assets, which are expected to provide future benefits in the form of a claim to future cash. Some financial instruments are called *securities* and generally include stocks and bonds.
- Any transaction related to financial instrument includes at least two parties:

1) the party that has agreed to make future cash payments and is called the *issuer*;

2) the party that owns the financial instrument, and therefore the right to receive the payments made by the issuer, is called the *investor*.

Types of financial assets

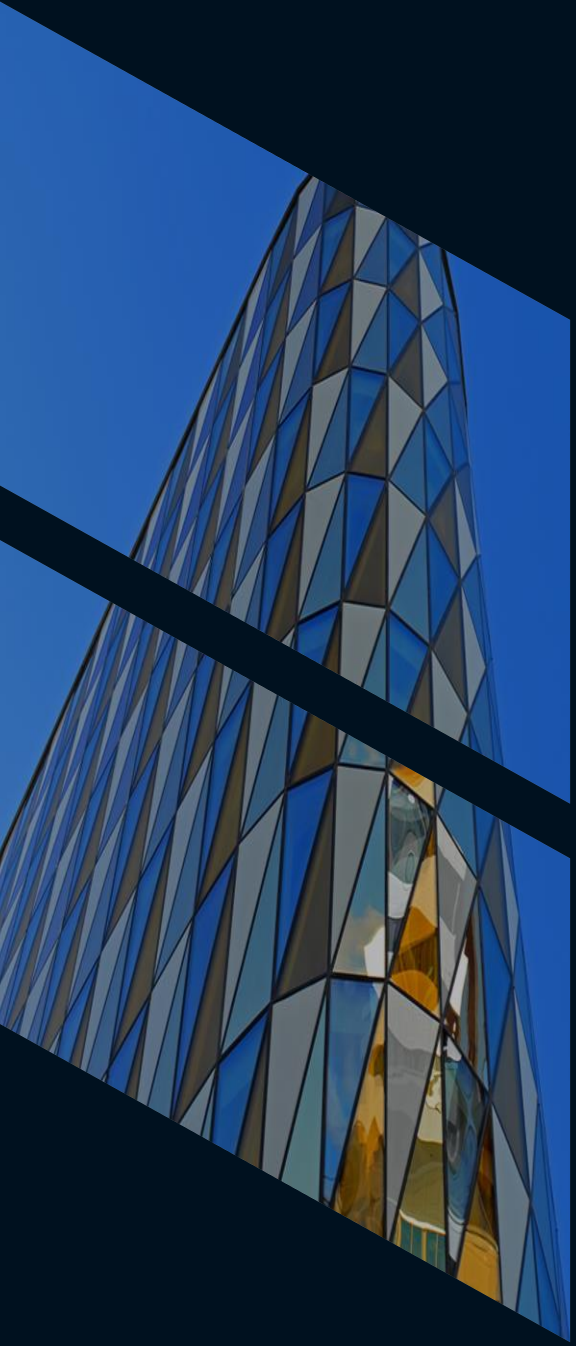
- Bank loans
- Government bonds
- Corporate bonds
- Municipal bonds
- Foreign bond
- Common stock
- Preferred stock
- Foreign stock

Financial assets

- Financial assets provide the following key economic **functions**.

1. they allow the transfer of funds from those entities, who have surplus funds to invest to those who need funds to invest in tangible assets;
2. they redistribute the unavoidable risk related to cash generation among deficit and surplus economic units.

- The claims held by the final wealth holders generally differ from the liabilities issued by those entities who demand those funds. They role is performed by the specific entities operating in financial systems, called **financial intermediaries**. The latter ones transform the final liabilities into different financial assets preferred by the public.



Financial instruments

There is a great variety of financial instrument in the financial marketplace. The use of these instruments by major market participants depends upon their offered risk and return characteristics, as well as availability in retail or wholesale markets. The general view on the financial instrument categories is provided in Table 1.

Category	Risk determinants	Expected returns	Main participants
Non-tradables and non-transferables	In wholesale money markets: transaction volumes	In wholesale money markets: low	In wholesale money markets: banks
	In retail markets: low transparency, lack of standardisation, low creditworthiness	In credit markets: low	In retail markets: banks and non-bank firms and households
	In foreign exchange markets: high volatility, change of currency	In foreign exchange markets: high	In foreign exchange markets: financial institutions, companies
Securities	Market volatility, individual risks and failures	Comparably high	Banks and non-bank firms, individuals
Derivatives	Market volatility, leverage	Very high	Banks and non-bank firms, individuals

Financial markets

Definition:

- A financial market is a market where financial instruments are exchanged or traded. Financial markets provide the following three major **economic functions**:

1) Price discovery – means that transactions between buyers and sellers of financial instruments in a financial market determine the price of the traded asset.

2) Liquidity - function provides an opportunity for investors to sell a financial instrument, since it is referred to as a measure of the ability to sell an asset at its fair market value at any time.

3) Reduction of transaction costs - is performed, when financial market participants are charged and/or bear the costs of trading a financial instrument.

Financial markets

Classification:

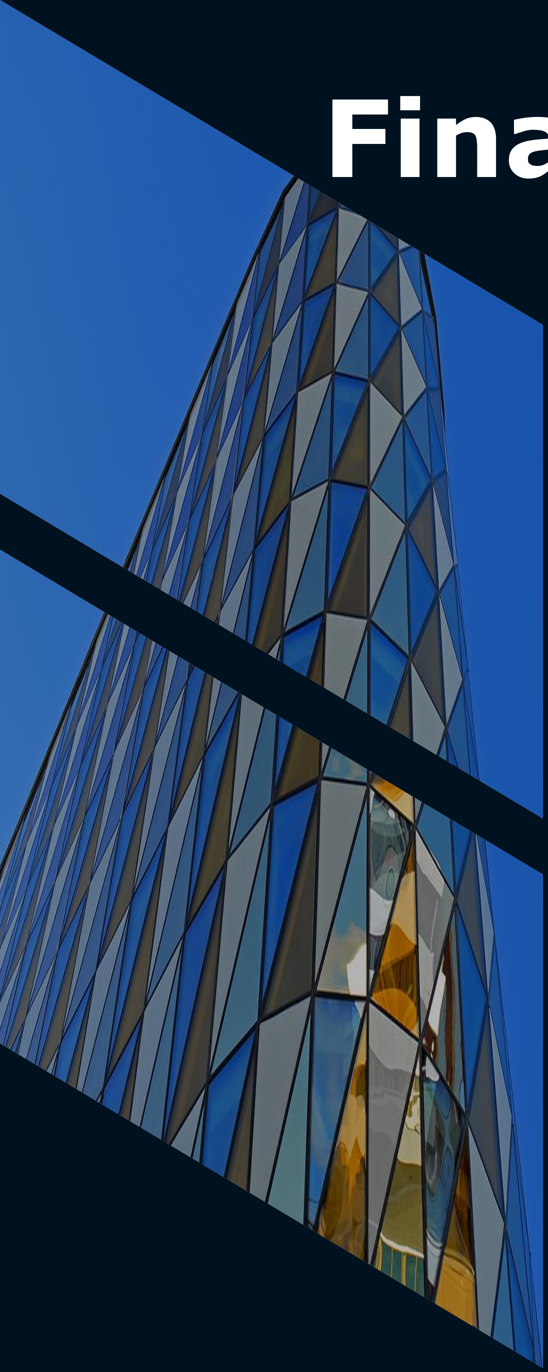
- From the perspective of country origin, its financial market can be broken down into an internal market and an external market. The **internal market**, also called the **national market**, consists of two parts: the domestic market and the foreign market. The **domestic market** is where issuers domiciled in the country issue securities and where those securities are subsequently traded. The **foreign market** is where securities are sold and traded outside the country of issuers.
- **Money market** is the sector of the financial market that includes financial instruments that have a maturity or redemption date that is one year or less at the time of issuance. These are mainly **wholesale markets**.
- The **capital market** is the sector of the financial market where long-term financial instruments issued by corporations and governments trade.
- Financial markets can be classified in terms of **cash market** and **derivativ** **markets**.

Financial markets

Classification:

- When a financial instrument is first issued, it is sold in the **primary market**. A **secondary market** is such in which financial instruments are resold among investors. No new capital is raised by the issuer of the security. Trading takes place among investors.
- **Stock exchanges** are central trading locations where financial instruments are traded. In contrast, an **OTC market** is generally where unlisted financial instruments are traded.

Financial markets classification



- There are different ways to classify financial markets. They are classified according to the financial instruments they are trading, features of services they provide, trading procedures, key market participants, as well as the origin of the markets.

Criterion	Features	Examples
Products	Tradability, transferability, ownership, maturity, denomination, substance	Equity, debt instruments, derivatives
Services	Technical, advisory, information and knowledge-based, administrative	IT support, research and analysis, custody
Ways of trading	Physical, electronic, virtual	Over the counter, exchange, internet
Participants	Professionals, non-professionals, institutions, officials	Banks, central banks, non-bank financial companies, institutional investors, business firms, households
Origin	Domestic, cross-border, regional, international	National markets, regionally integrated markets, Euromarkets, domestic/foreign currency markets, onshore/offshore markets

Source: Reszat B. (2008). European Financial Systems in the Global Economy.

Financial intermediaries

Definition:

- **Financial intermediary** is a special financial entity, which performs the role of efficient allocation of funds, when there are conditions that make it difficult for lenders or investors of funds to deal directly with borrowers of funds in financial markets. Financial intermediaries include depository institutions, insurance companies, regulated investment companies, investment banks, pension funds.

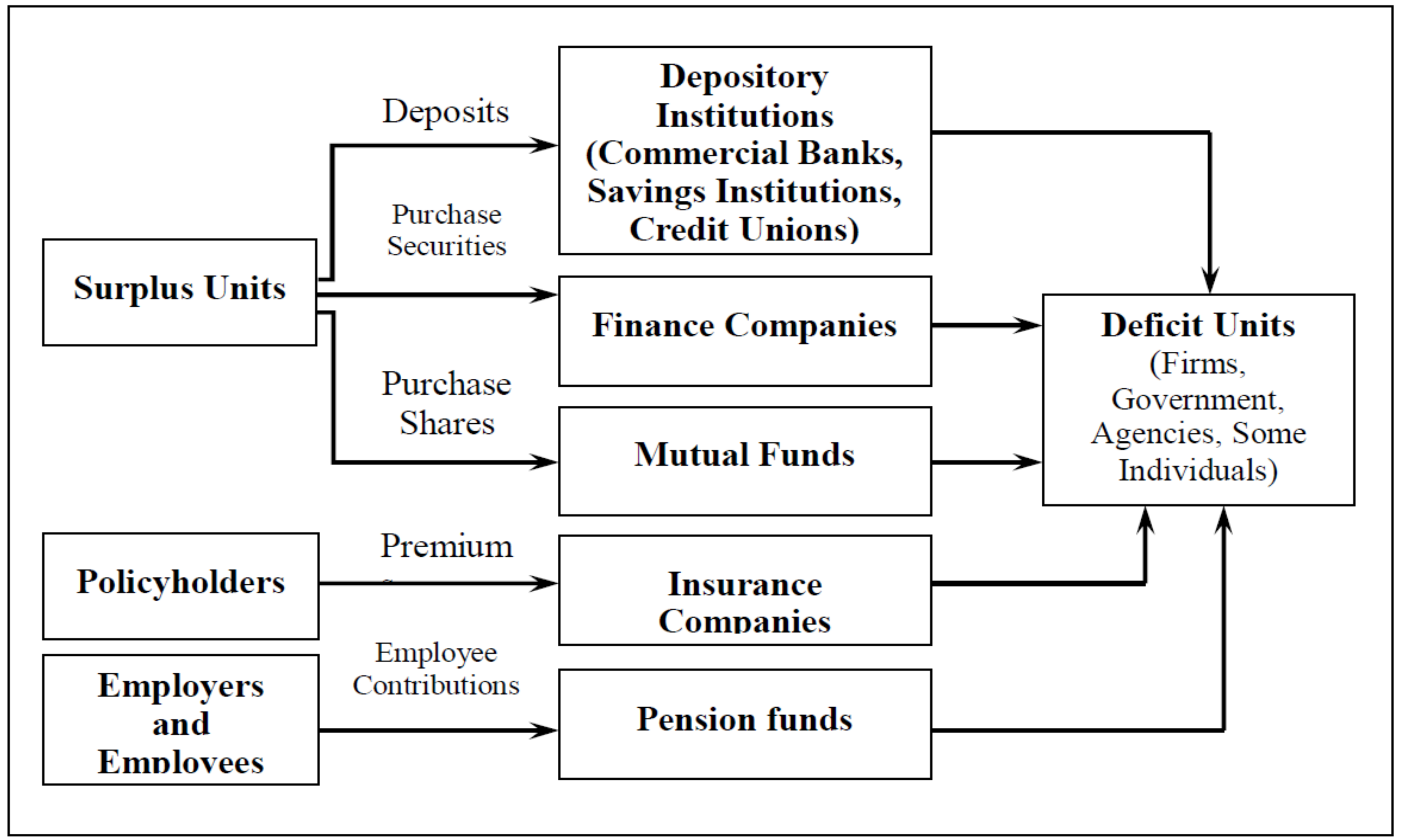
Financial intermediaries and their functions

- The role of financial intermediaries is to create more favourable transaction terms than could be realized by lenders/investors and borrowers dealing directly with each other in the financial market.
- The financial intermediaries are engaged in:

1. obtaining funds from lenders or investors and
2. lending or investing the funds that they borrow to those who need funds.

- The funds that a financial intermediary acquires become, depending on the financial claim, either the liability of the financial intermediary or equity participants of the financial intermediary. The funds that a financial intermediary lends or invests become the asset of the financial intermediary.

Comparison of roles among financial institutions



THANK YOU!

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