FINANCIAL MANAGEMENT

Lecture 3

THE FINANCIAL SYSTEM

A country's financial system consists of entities that help facilitate the flow of funds from those that have funds to invest to those who need funds to invest.

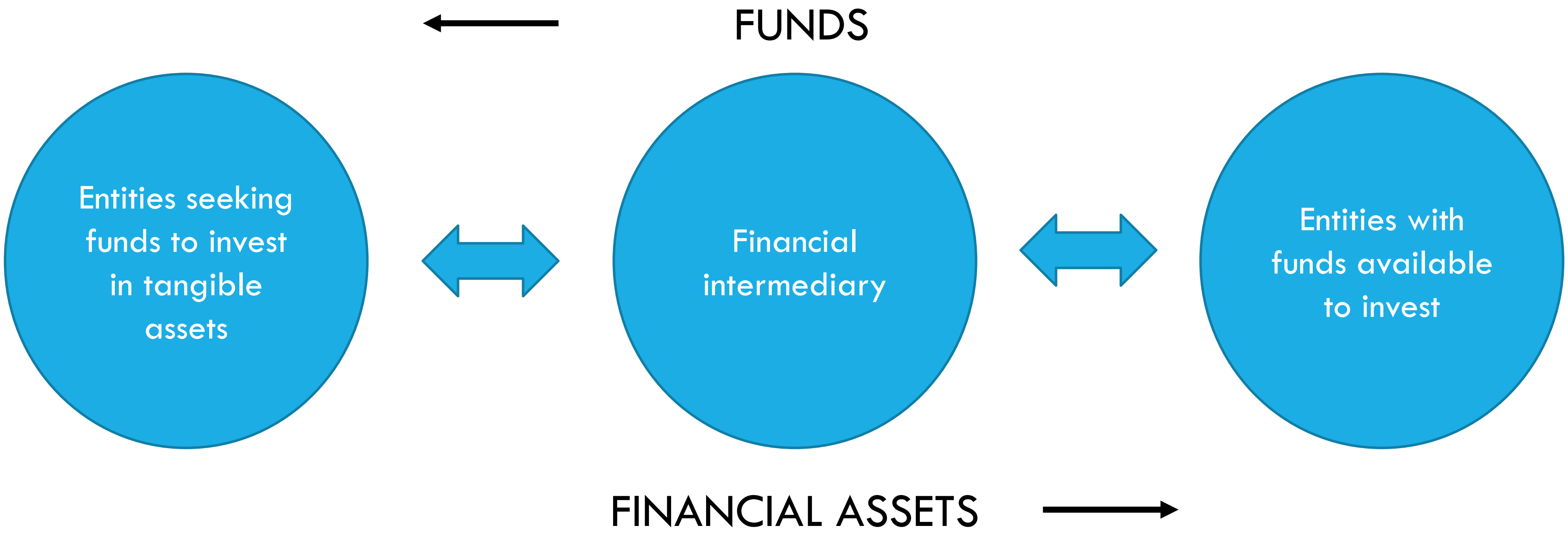
In lending and investing situations, there is not only the trouble of dealing directly with the other party or parties, but there is also the problem that one party has a different information set than the other. There is *information asymmetry*.

A financial system makes possible a more efficient transfer of funds by mitigating the information asymmetry problem between those with funds to invest and those needing funds.

In addition to the lenders and borrowers, the financial system has three components:

- Financial Markets
- Financial Intermediaries
- Regulators

THE ROLE OF FINANCIAL INTERMEDIARY



FINANCIAL ASSETS

An *asset* is any resource that we expect to provide future benefits and has economic value.

Two types of assets:

- Tangible assets: The value of a tangible asset depends on its physical properties. Also known as *fixed assets*.
- Intangible assets: It represents a legal claim to some future economic benefit or benefits.
- *Financial assets*, such as stocks and bonds are also intangible assets because the future benefits come in the form of a claim to future cash flows.
- Financial assets are also known as *financial instruments*, certain types of financial instruments are referred to as *financial securities*.
- For every financial asset there is a minimum of two parties:
  - *Issuer*: The party that has agreed to make future cash payments.
  - *Investor*: The party that owns the financial instrument and therefore, the right to receive the payments made by the issuer.

WHY DO WE NEED FINANCIAL ASSETS?

They allow the transference of funds from those entities that have surplus funds to invest to those who need funds to invest in tangible assets.

They permit the transference of funds in such a way as to redistribute the unavoidable risk associated with the tangible assets cash flow among those seeking and those providing the funds.

THE DIFFERENCE BETWEEN DEBT AND EQUITY

Financial instruments are classified by the type of claims that the investor has on the issuer.

A financial instrument in which the issuer agrees to pay the investor interest, plus repay the borrowed amount, is a *debt instrument* or simply, *debt*.

A debt can be in the form of a note, bond or loan.

The issuer must pay interest payments which are fixed contractually.

The amount may be a fixed dollar amount or percentage of the face value of the debt, or it can vary depending upon some benchmark.

The investor who lends the funds and expects interest and the repayment of the debt is a *creditor* of the issuer.

The key point is that the investor in a debt instrument can realize no more than the contractual amount. For this reason, we often refer to debt instruments as *fixed income instruments*.

THE DIFFERENCE BETWEEN DEBT AND EQUITY

An *equity instrument* specifies that the issuer pay the investor an amount based on earnings, if any, after the obligations that the issuer is required to make to the company's creditors are paid.

Common stock and *partnership shares* are examples of equity instruments.

Common stock is the ownership interest in a corporation, whereas a partnership share is an ownership interest in a partnership.

Any distribution of a company's earnings are known as *dividends*.

PREFERRED STOCK

Preferred stock is a hybrid stock because it looks like debt because investors in this security are only entitled to receive a fixed contractual amount.

Yet it is similar to equity because the payment to investors is only made after obligations to the company's creditors are satisfied.

Because preferred stockholders typically are entitled to a fixed contractual amount, we refer to preferred stock as a fixed income instrument.

Hence, fixed income instruments include debt instruments and preferred stock.

CONVERTIBLE BOND OR CONVERTIBLE NOTE

A *convertible bond* or *note* is a debt instrument that allows the investor to convert it into shares of common sock under certain circumstances and at a specified exchange ratio.

The classification of debt and equity is important for two legal reasons:

- First, in the case of bankruptcy of the issuer, investors in debt instruments have a priority on the claim on the issuer's assets over equity investors.
- Second, the tax treatment of the payments by the issuer differs depending on the type of class.
- Specifically, interest payments made on debt instruments are tax deductible to the issuer, whereas dividends are not.

THE ROLE OF FINANCIAL MARKETS

Investors exchange financial instruments in a financial market.

Financial markets provide the following three major economic functions:

- *Price discovery*: means that the interactions of buyers and sellers in a financial market determine the price of the traded asset.
- *Liquidity*: is the presence of buyers and sellers ready to trade.
- *Reduction in transaction costs*: Two types of costs, *search costs* and *information costs*.
  - Search costs fall into two categories: *explicit costs* and *implicit costs*.
  - Explicit costs include expenses to advertise one's intention to sell or purchase a financial instrument.
  - Implicit costs include the value of time spent on locating a *counterparty*.
  - The presence of some form of organized financial market reduces search costs.
  - Information costs are costs associated with assessing financial instrument's investment attributes.

THE ROLE OF FINANCIAL INTERMEDIARIES

A financial intermediary comes into play 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, non-deposit finance companies, regulated investment companies, investment banks and insurance companies.

The role of financial intermediaries is to create more favorable transaction terms that could be realized by lenders/investors and borrowers dealing directly with each other in the financial market.

Financial intermediaries accomplish this in a two-step process:

- Obtaining funds from lenders or investors.
- Lending or investing the funds that they borrow to those who need funds.