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Readings in Finance and Banking

القراءات

المرحلة الاولى

أعداد

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Chapter 1: The Fundamental Concept of Finance

What is Finance?

Generally, **finance** is the study of how individuals, institutions, governments, and businesses acquire, spend, and manage money and other financial assets.

In simple terms, **finance** is a study that "concerned with decisions about money, or cash flows." Understanding finance is important to all students regardless of their areas of study because there are financial implications in nearly all business and economic decisions. Finance decisions deal with how money is raised and used by businesses, governments, and individuals. Everyone deals with financial decisions, both in business and in their personal lives. Therefore, to make sound financial decisions you must understand three general ideas:

(1) More value is preferred to less;

(2) The sooner cash is received, the more valuable it is:

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

Firms that make decisions with these concepts will be able to provide better products to customers at lower prices, pay higher salaries to employees, and provide greater returns to investors.

2. Sources of Financing

Sources of financing can be divided into:

A. Internal sources of financing (come from inside the organization)

B. External sources of financing (come from an outside sources)

2.1. Internal sources of financing

There are four internal sources of financing:

1. **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.

Advantages

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

Disadvantages

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

2. Retained earnings

This source of financing 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.

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

3. Sale of fixed assets

This money comes from selling off fixed assets, such as buildings that are no longer needed.

Advantages

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

Disadvantages

- Some businesses don't have surplus assets to sell
- Can be a slow method of raising finance
- There are a limit number of fixed assets that firms can sell off.

4. Debt collection

A debtor is someone who owes money. Companies can raise money by collecting the money owed to them (debts) from their debtors.

Advantages

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

Disadvantages

- There is a risk that debts are not be repaid (bad debts)

2.2. External sources of financing

There are some external sources of financing:

1. Bank loan or Overdraft

This is money borrowed at an agreed rate of interest over a set period of time.

Advantages

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

Disadvantages

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

2. Additional partners

This source of financing is 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

- Could lead to a lack of control for the partnership
- Profit will be split to more partners

3. Shares issue

This source of financing is suitable for limited companies because it involves more shares.

Advantages

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

Disadvantages

- Profits will be paid out to more shareholders
- Could lead to change of the ownership

4. Leasing

This method allows a business to obtain assets without the need to pay a large amount of money up front.

Advantages

- It is allowed to companies to use up to date equipment immediately
- It has tax advantages
- leasing allows companies to utilize many assets without increasing their cash outflow

Disadvantages

- The asset belongs to the finance company

5. Hire purchase

This method allows a business to obtain assets without need to pay a large amount of money up front. It 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.

Advantages

- It is allowed to companies to 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

6. Mortgage

This is a loan secured on property. People have repaid in installments over a period of time typically 25 years. The business will own the property once the final payment has been made.

Advantages

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

Disadvantages

- This is an expensive method compared to buying with cash
- If companies default on repayments, the property could be repossessed

7. Government grants

Some government organizations offer grants to businesses. Usually require certain conditions

Advantages

- Don’t have to be repaid

Disadvantages

- Not all businesses may be eligible for the grants

4. Financial Instruments

Financial instruments refer to the documents that represent financial claims on assets. It refers to a claim to the repayments of a sum at the end of specific period together with interest or dividends. For instance, bill of exchange, debenture, government bonds, Treasury bill, etc.

4.1. Features of Financial Instruments

- They are easy transferable
- They can be used as a security for raising loans
- Some of them have tax saving
- They have specific maturity period

4.2. Types of Financial Instruments

Financial Instruments can be classified into two broad groups: debt instruments and equity instruments.

Debt: is a loan to an individual, company, or a government. There are many types of debt instruments exist such as home mortgages, commercial paper, etc.

Debt Features:

Often, people identify debt by describing three of its features; the principal value, the interest payment, and the time to maturity. The following discussion will describe some of the general features associated with debt.

1. ***Priority to assets and earnings***

Debt holders have priority over stockholders with regard to distribution of earnings and liquidation of assets. They must be paid before any stockholders can be paid. Interest on debt is paid before stock dividends are distributed, and any outstanding debt must be repaid before stockholders can receive any proceeds from liquidation of the company.

2. Principle Value, Face Value, Maturity Value

The principal value of debt represents the amount owed to the lender, which must be repaid at during the life of the debt. In addition, the principal value generally is written on the "face"- the outside cover- of the debt instrument, so it is sometimes called the face value.

3. Interest payments:

In many cases, investors in (owners of) debt instruments receive periodic payments of interest, which are computed as a percentage of outstanding principal amounts. Some securities are selling for less than their par value which called selling at "discount".

4. Maturity date

The maturity date represents the date on which principal amount of debt is due. Firms will continue to pay interest as long as the principle is not fully repaid. Some debt instruments require the principal amount to be repaid in several payments during the life of the loan which is called installment loans. In such cases, the maturity date is the date of the last installment payment is due.

5. Control of the firm (Voting Rights)

Debt holders do not have voting rights, so they cannot attain corporate control. Nevertheless, debt holders can affect the management and the operations of a firm by placing restrictions on the use of the borrowed funds as part of the loan agreement.

4.2.1. Debt Instruments are an obligation of the issuer (borrower) to pay a specified amount (principal amount borrowed plus interest) at a specified date in the future to the investor. Examples of debt instruments are bills, bonds, etc.

Bills: represent a short-dated security, usually maturity in under a year. Examples of bills are Treasury bills, Commercial Paper, etc.

Treasury bills*:* (known as T-bills) are debt instruments issued by the government to finance government operations. Treasury bills do not pay any interest, but they are issued at a discount. They have maturities range from 91 days to one year. They are also the safest of all money market instruments, because there is almost no possibility of default.

Commercial Paper: is a short-term debt instrument issued by large banks and well-known corporations, such as General Motors. Commercial paper does not pay interest, so it must be sold at discount. The maturity on commercial paper varies from one to nine months. Generally, commercial paper is issued in denominations of $100,000 or more.

Certificate of Deposit (CD): represents a time deposit at a bank or other financial intermediary. Basically, it is a debt instrument, sold by a bank to depositors, that pays annual interest of a given amount and at maturity pays back the original purchase price. They could not sell to someone else and could not be redeemed from the bank before maturity without paying a substantial penalty. Moreover, it has maturity range from a few months to a few years.

Bonds

A bond is a long-term contract under which a borrower agrees to make payments of interest and principal on specific dates to the bondholder. The interest payments are determined by the coupon rate and the principle (face value) of the bond. The coupon rate represents the total interest paid each year, stated as a percentage of bond's face value. Moreover, there are many kinds of bonds such as government bonds, corporate bonds, mortgage bonds, debenture bonds.

Equity: generally, is defined as the value of assets that are owned minus the amount of debt that is owed. 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
In addition to economic rights, equity claims confer ownership rights to equity holders.

4.2.2. **Equity Instruments**

Each corporation issues at least one type of stock, or equity, called common stock. Some corporations issue more than one type of common stock, such as preferred stock in addition to common stock.

Common stock

Common stockholders receive dividends only after the preferred stockholders and the interest on debt are paid. The firm has no obligation to pay common stock dividends. Even though some pay relatively constant dividends, other firms do not pay dividends at all. In case of liquidation that resulting from bankruptcy, common stockholders do not receive funds unless preferred stockholders are paid.

Preferred stock

Preferred stockholders have preference over common stockholders when a firm distributes funds to stockholders and dividends. Generally, preferred stockholders receive the same dividends every year, regardless of the company's earnings or growth during the year. In case of liquidation that resulting from bankruptcy, preferred stockholders are paid before common stockholders. Preferred stockholders usually do not have voting right. Moreover, most preferred stocks that have been issued in recent years have the ability to convert into common stock.

5. Financial Institutions:

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). Also, they are known as financial intermediaries. Basically, specialized financial firms that are facilitate the indirect transfer of funds from savers to borrowers by offering savings instruments, such as pension plans and borrowing instruments, such as mortgages.

We can divide intermediaries into two broad types:

- **Depository Institutions:** financial institutions that accept deposits from individuals and provide loans such as:
- ***Commercial banks:*** financial institutions that accept deposits and use the funds to provide commercial and personal loans.
- ***Saving institutions (thrift institutions):*** financial institutions that accept deposits and provide mortgage and personal loans to individual. Moreover, thrift institutions are financial institutions that cater to savers, especially individuals who have relatively small savings and borrowers who need long-term loans to purchase houses.
- ***Credit unions:*** 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 non-for-profit businesses and are managed by members 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:*** Insurance companies receive premiums (which they invest) from policy-holders and promise to pay compensation to policy-holders if particular event 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.

- ***Finance companies:*** finance companies make loans to individuals and corporations by providing consumer lending, business lending and mortgage financing. Finance companies acquire funds by issuing commercial paper or stocks and bonds or borrowing from banks.

Chapter 2: Money (Meaning & Functions)

What is Money?

Economists define money (also referred to as the money supply) as anything that is generally accepted in payment for goods or services or in the repayment of debts. Currency, consisting of dollar bills and coins, clearly fits this definition and is one type of money. When most people talk about money, they're talking about currency (paper money and coins). To define money merely as currency is much too narrow for economists. Because checks are also accepted as payment for purchases, checking account deposits are considered money as well. An even broader definition of money is often needed, because other items such as savings deposits can in effect function as money if they can be quickly and easily converted into currency or checking account deposits. As you can see, there is no single, precise definition of money or the money supply, even for economists.

Functions of Money

Whether money is gold or paper, it has four primary functions in any economy: as a medium of exchange, as a unit of account, as a store of value and standard of deferred payments. Of the three functions, its function as a medium of exchange is what distinguishes money from other assets such as stocks, bonds, and houses.

A. Medium of Exchange

In almost all market transactions in our economy, money in the form of currency or checks is a medium of exchange; it is used to pay for goods and services. The use of money as a medium of exchange promotes economic efficiency by minimizing the time spent in exchanging goods and services.

B. Unit of Account

The second role of money is to provide a unit of account; that is, it is used to measure value in the economy. We measure the value of goods and services in terms of money, just as we measure weight in terms of pounds or distance in terms of miles.

C. Store of Value

Money also functions as a store of value; it is a repository of purchasing power over time. A store of value is used to save purchasing power from the time income is received until the time it is spent. This function of money is useful, because most of us do not want to spend our income immediately upon receiving it, but rather prefer to wait until we have the time or the desire to shop.

D. Standard of deferred payment

Money helps to credit transactions (i.e. exchange present goods on credit) through its function as a standard of deferred payments. Money must maintain a constant value through time. There are many contracts promise to pay fixed sums of money into the future.

Evolution of the Payments Systems

The payments system has been evolving over centuries and with it the form of money. At one-point, precious metals such as gold were used as the principal means of payment and were the main form of money. Later, paper assets such as checks and currency began to be used in the payments system and viewed as money. Where the payments system is heading has an important bearing on how money will be defined in the future.

Commodity Money

To obtain perspective on where the payments system is heading, it is worth exploring how it has evolved. For any object to function as money, it must be universally acceptable; everyone must be willing to take it in payment for goods and services. An object that clearly has value to everyone is a likely candidate to serve as money, and a natural choice is a precious metal such as gold or silver. Money made up of precious metals or another valuable commodity is called commodity money, and from ancient times until several hundred years ago, commodity money functioned as the medium of exchange in all but the most primitive societies. The problem with a payments system based exclusively on precious metals is that such a form of money is very heavy and is hard to transport from one place to another.

Fiat Money

The next development in the payments system was paper currency (pieces of paper that function as a medium of exchange). Initially, paper currency carried a guarantee that it was convertible into coins or into a quantity of precious metal. However, currency has evolved into fiat money, paper currency decreed by governments as legal tender (meaning that legally it must be accepted as payment for debts) but not convertible into coins or precious metal. Paper currency has the advantage of being much lighter than coins or precious metal, but it can be accepted as a medium of exchange only if there is some trust in the authorities who issue it and if printing has reached a sufficiently advanced stage that counterfeiting is extremely difficult. Because paper currency has evolved into a legal arrangement, countries can change the currency that they use at will.

Checks

A check is an instruction from you to your bank to transfer money from your account to someone else's account when she deposits the check. Checks allow transactions to take place without the need to carry around large amounts of currency. The introduction of checks was a major innovation that improved the efficiency of the payments system. Frequently, payments made back and forth cancel each other; without checks, this would involve the movement of a lot of currency. With checks, payments that cancel each other can be settled by canceling the checks, and no currency need be moved. The use of checks thus reduces the transportation costs associated with the payments system and improves economic efficiency. Another advantage of checks is that they can be written for any amount up to the balance in the account, making transactions for large amounts much easier. Checks are also advantageous in that loss from theft is greatly reduced, and because they provide convenient receipts for purchases.

Electronic Payment

The development of inexpensive computers and the spread of the Internet now make it cheap to pay bills electronically. In the past, you had to pay your bills by mailing a check, but now banks provide a web site in which you just log on, make a few clicks, and thereby transmit your payment electronically. Not only do you save the cost of the stamp, but paying bills becomes (almost) a pleasure, requiring little effort. Electronic payment systems provided by banks now even spare you the step of logging on to pay the bill. Instead, recurring bills can be automatically deducted from your bank account. Estimated cost savings when a bill is paid electronically rather than by a check exceed one dollar. Electronic payments technology can not only substitute for checks, but can substitute for cash, as well, in the form of **electronic money (or e-money),** money that exists only in electronic form. The first form of e-money was the debit card. Debit cards, which look like credit cards, enable consumers to purchase goods and services by electronically transferring funds directly from their bank accounts to a merchant's account. Debit cards are used in many of the same places that accept credit cards. At most supermarkets, for example, you can swipe your debit card through the card reader at the checkout station, press a button, and the amount of your purchases is deducted from your bank account.

Chapter 3: Financial Market

The fundamental concept of 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. Basically, the financial markets define as a system that includes individuals, 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).
2. Promote economic efficiency by producing an efficient allocation of capital, which increase production.
3. Directly improve the well-being of consumers by allowing them to time purchases better.

Types of Financial Markets

1. **Primary Markets:** markets in which include various organizations raise funds by issuing new securities (capital formation occurs).
2. **Secondary Markets:** markets where securities that have been previously issued are traded among investors.
3. **Money Markets:** are financial markets where only short-term debt instruments (maturity of less than one year) are traded such as Commercial Paper.
4. **Capital Markets:** are markets in which long-term securities are traded such as Government Bonds, Common Stock and Preferred Stock.

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