Financial sector

Finance, Investment

Financial markets and institutions play a big role in the financial sector. They can help resolve the mismatch between the needs and surplus units in the economy. When looking at this risk, term and return cannot be over looked. So, what is a financial market? Basically it's a place within which financial instruments can be bought and sold (for example the London stock exchange). Financial markets deal in marketable financial claims. These are one that can be bought or sold from another individual. Such things as shares and stocks are what is normally traded and usually through a stockbroker.

There are many types of markets under two main titles, moneymarkets and capital markets. Basically, money markets deal with short-term (less than 5 years) borrowers and lenders funds. Capital markets deal with medium (5-15 years) and long-term (more then 15 years) borrowers and lenders funds. Financial institutions can be looked at as large profit maximising firms that borrow funds from lenders and lend them to borrowers. They mainly gain profits from charging interest to borrowers at a rate that exceeds that paid to lenders.

Theses profits are gained for the shareholders. Apart from creating 'loans' what else do financial institutions do? Well, they act as intermediaries, the middleman or go between for two parties. The parties being lenders and borrowers, or surplus and deficit units. The intermediaries keep a record of people with money top lend and people who wish to borrow. The firm would try and find a potential lender whose desires match that of a potential borrower, it would then charge a commission for introduction them.

For example, a person wanting to buy a flat for 80, 000 intending to repay the loan over 30 years. Without an intermediary the person has to find someone with 80, 000 to lend for this period of time. Highly unlikely. Not many people have that money to lend especially to a comparative stranger. If a financial intermediary stepped in (building society) this might operate by taking large numbers of small deposits on which they pay themselves interest. Which could then be used to make larger loans.

This is beneficial to both parties, savers can loan and earn interest on small sums, and can get their deposit back on short notice (as society will have reserves). And borrowers can borrow money at a reasonable rate of interest. In developed economies there will always be individuals and firms whose consumption will not be as less than there income supports, which means they will have money to save. This saving may be used for an investment to but assets such as machinery or premises if you were a company.

There will be individuals who save but undertake no physical investment (they will have a financial surplus). This surplus can be used for lending. Lenders will want to minimize risk (maximizing liquidity) and maximize return. On the other hand there are firms, individuals and public authorities whose expenditure exceeds their income. This can only be achieved if they draw on past savings or borrow. This be spent on real assets or investment, People may borrow to purchase financial assets.

This happened when during the sale of BP share in 1987 where people thought the gains from acquiring the asset would be greater than the cost of the liability, the debt into which they entered to buy the share. What risk is

involved in lending and borrowing? Well, the main risk is the possibility that a future outcome will differ from the expected outcome. This risk can arise in a number of ways. The borrower could fail to pay interest or to repay the loan at the date originally agreed (default risk).

The rate of return available may be different from what was expected from a maturing asset are reinvested, this is known as reinvestment loan, Capital risk is where the asset has a different value from what was first expected when it is sold or matures. An example of a firm not controlling risk would be Merrill Lynch who were accused of negligently investing 1 billion of pension fund money, for which USF are seeking i?? 130 million of damages. Another would be Railtrack who has had operations suspended by the government because all there money has gone, while shareholders want money back.

This is an example of the asset having a different value than expected Financial institutions are able to reduce risk through a number of ways, the two main ones being diversification and specialist management. Having just one asset is more likely to have unexpected outcomes than holding a number of assets or a 'portfolio'. Savers encouraged to buy units in a trust fund or life assurance then the managers of those funds can distribute it among a wide variety of securities than a single individual could manage.

Assets do not all behave in the same way so if you have diversified and one share or stock goes down in price then another one is bound to have gone up. The main reason people will lend is for the return. The return can be in many forms. It may be an interest payment. This could be a fixed Payment (no matter if interest rate rise or fall the interest payment on loan will remain

the same). Another return would be a dividend payment; this normally reflects the borrowers ability to pay.

On a good year the borrower will pay back more on a bad year the dividend payment will be less. A third yield could be appreciation in capital value of the asset. Government stock that bears a fixed interest rate also has a fixed date and value at which it will be redeemed. If market interest rates have forced the market value of stock below its redemption value, buying the stock and holding it till redemption will produce a capital gain. Risk, term and return are all in a way linked. The longer the term of investment the greater the risk and, thus greater the expected return.