

Introduction

Categories of economic units

- Government Sector
- Includes
- Federal government
- State government
- Local governments like municipalities

Business sector



Household sector



Relationship between income and expenditure

- There are 3 possible relationships between income and expenditure
- *Balanced budget units (BBUs)*
- Income = Expenditure
- *Surplus budget units (SBUs)*
- Income > Expenditure
- *Deficit budget units (DBUs)*
- Income < Expenditure

Function of financial system

- To channelize purchasing power from SBUs to DBUs.



Financial Claims

- When an SBU transfers funds to a DBU, the DBU will issue a financial claim.

• SBU ————— Money DBU —————>

• DBU —————> Claim —————> SBU

Claims

- If the transaction takes the form of a loan, the claim is said to constitute a *Debt* Instrument.
- However if the provider of the fund were to seek an ownership stake in the venture, the claim would be classified as an *Equity Share*

Overview of financial markets

- Financial markets: Structures through which funds flow.
- Distinction along two dimensions:
 - 1. Primary versus secondary markets
 - 2. Money versus capital markets

Primary markets

- Markets in which corporations raise funds through new issues of financial instruments, such as stocks and bonds.
- Government raises funds through issuing bonds.
- Initial Public Offering and/or Private Placement

Initial public offering

- First public issue of financial instruments by a firm
- Electrical Industries Company's IPO in 2014

Private placement

- Securities issuer seeks to find an institutional buyer or group of buyers to buy the whole issue

Seasoned equity offering or follow-on offering

- Issue of additional equity or debt instruments of an already publicly traded firm

Role of investment banks

- Transactions are facilitated by investment banks like Saudi Fransi Capital or Alkhair Capital
- Provides the securities issuer (the fund user) with advice on the securities issue (such as offer price and number of securities to issue) and attracts the initial public purchasers of the securities for the funds user.
- Saves the fund user from risk and cost of creating a market for its securities on its own

Secondary markets

- Financial instruments issued in primary markets are then traded
- Markets in which financial instruments are traded among investors. (Tadawul)
- Buyers of secondary market securities are economic agents (consumers, businesses, and governments) with excess funds

Secondary markets

- Sellers of secondary market financial instruments are economic agents in need of funds
- Provide a centralized market place where economic agents know they can transact quickly and efficiently
- Save economic agents the search and other costs of seeking buying or sellers on their own

Financial institution in secondary markets

- Securities broker
- E.g. Alinma Investment Company

Primary Markets

(Where new issues of financial instruments are offered for sale)



Secondary Markets

(Where financial instruments, once issued, are traded)



→ Financial instruments flow

← Funds flow

Money markets

- Markets that trade debt securities with maturities of less than one year

Capital markets

- Markets that trade debt and equity instruments with maturities of more than one year

Foreign exchange markets

- Trading one currency for another

Derivative security markets

- Markets in which derivative securities are traded

Derivative security

- An agreement between two parties to exchange
- standard quantity of an asset
- at a predetermined price on a specified price
- on a specified date in the future

Financial markets regulation

- Capital Market Law
- Capital Market Authority

Overview of financial institutions

- *Financial institutions*
- Institutions that perform the essential function of channelling funds from those with surplus funds to those with shortage of funds.

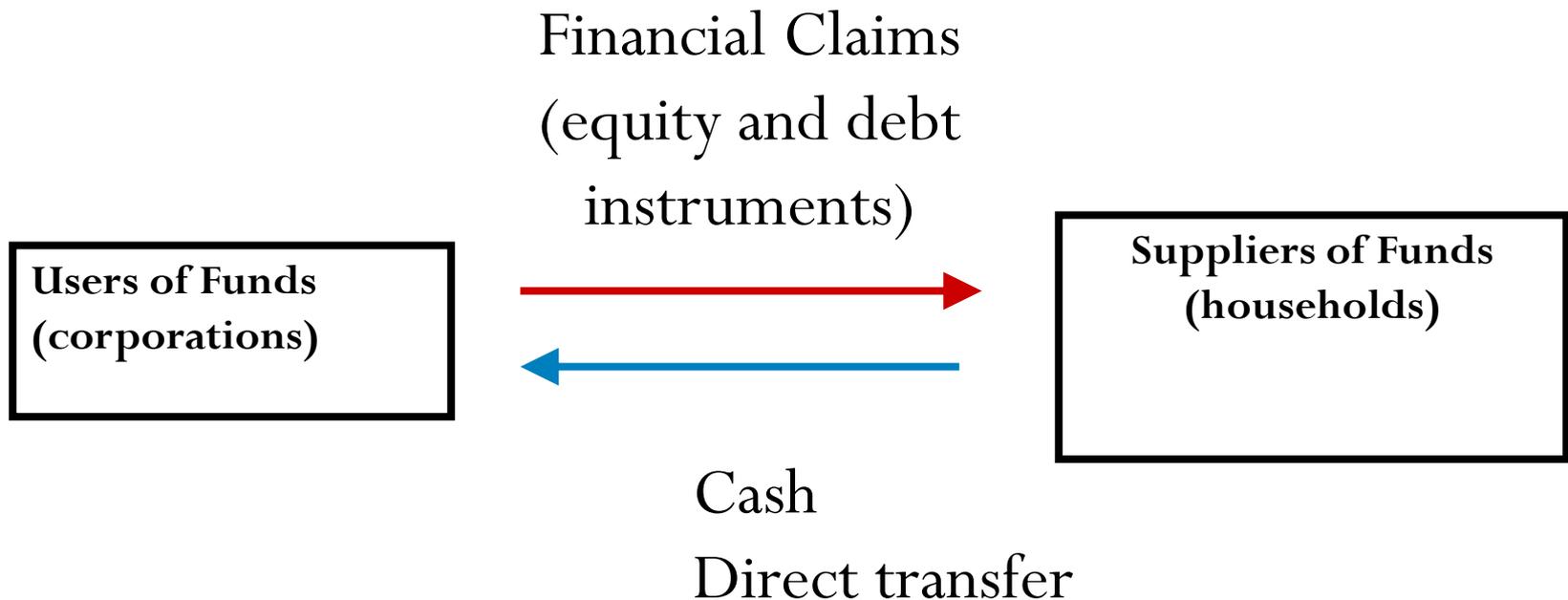
Financial institutions

- Banks
- Insurance companies
- Mutual funds
- Classified into depository and non-depository institutions

Depository versus non-depository financial institutions

- Depository institutions like banks
- Non-depository institutions like insurance companies, securities firms, investment banks, mutual funds, pension funds

Flow of Funds in a World without FIs



Direct transfer

- A corporation sells its stock or debt directly to investors without going through a financial institution
- Suppliers want to maximize the return on their funds subject to risk
- Users want to minimize their cost of borrowing subject to risk

Direct transfer

- Level of funds flow likely to be low
- 1. Monitoring
- 2. Liquidity
- 3. Price risk

Direct transfer

- Suppliers need to monitor the use of their funds continuously
- To check borrowers do not steal funds outright or wastes the funds on projects that offer low or negative returns

Direct transfer

- Why?
- Chance of being repaid and/or earning a positive rate of return gets lower
- Monitoring is expensive as it involves time, expense, and effort to collect information relative to the size of the average fund supplier's investment
- Lack of monitoring increases risk

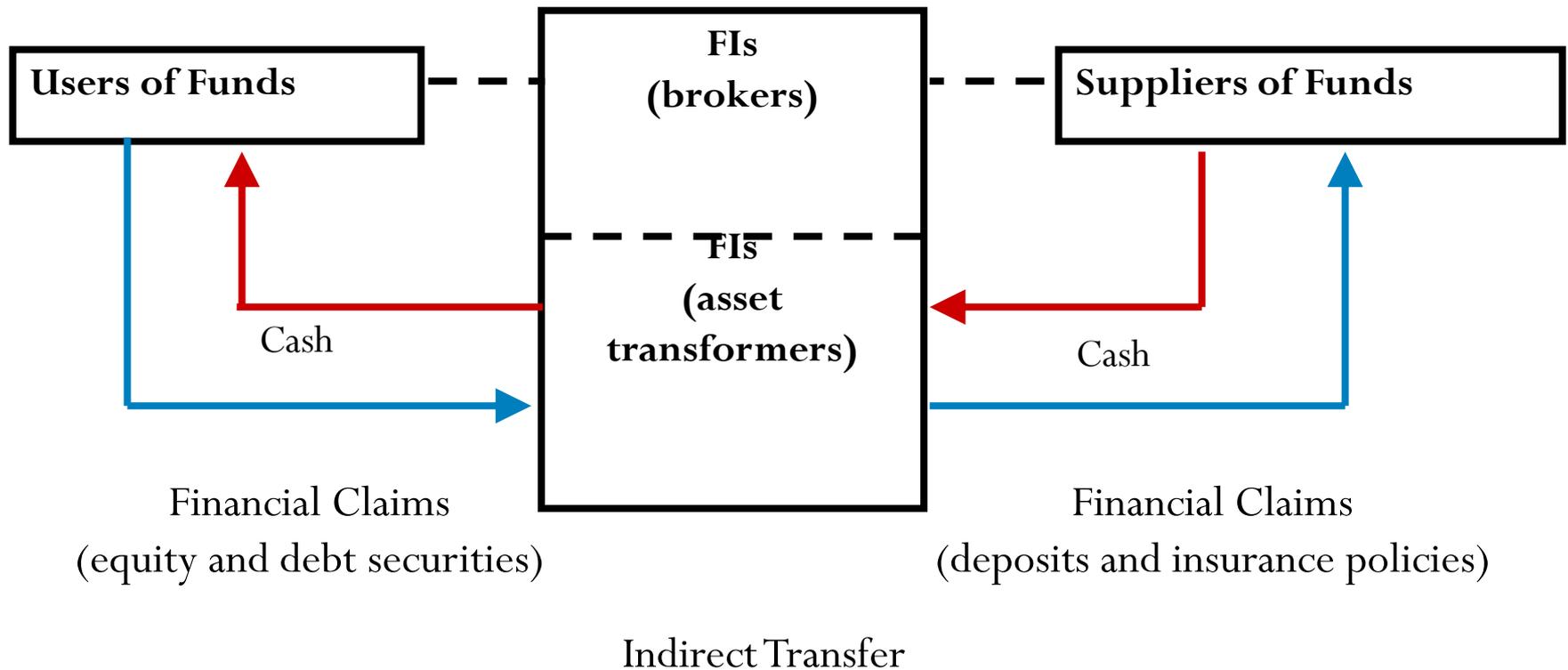
Direct transfer

- Liquidity is the ease with which an asset can be converted into cash at its fair market value
- Long-term nature of financial claims creates disincentive for suppliers of funds to hold the direct financial claims issued by users of funds
- If they plan to use their savings to finance consumption expenditures in near future and financial markets are not developed

Direct transfer

- Price risk is the risk that an asset's sale price will be lower than its purchase price

Flow of Funds in a World with FIs



Indirect transfer

- Transfer of funds between suppliers and users of funds through a financial intermediary

Unique economic functions performed by financial institutions

- Grouped into
- Services benefiting suppliers of funds
- Services benefiting the overall economy

Services benefiting suppliers of funds

Monitoring costs

- Aggregation of funds in an FI provides greater incentive to collect a firm's information and monitor actions
- Relatively large size of the FI allows this collection of information to be accomplished at a lower average cost
- Economies of scale

Monitoring costs

- *Delegated monitor:*
- An economic agent appointed to act on behalf of smaller investors in collecting information and/or investing funds on their behalf.

Liquidity and price risk

- FIs provide financial claims to household savers with superior liquidity attributes and with lower price risk.
- *Asset transformers:*
- Financial claims issued by an FI that are more attractive to investors than are the claims directly issued by corporations.

Liquidity and price risk

- *Diversify:*
- Ability of an economic agent to reduce risk by holding a number of securities in a portfolio.

Transaction cost services

- Economies of scale in transaction costs

Maturity intermediation

- FIs can better bear the risk of mismatching the maturities of their assets and liabilities

Denomination intermediation

- FIs such as mutual funds allow small investors to overcome constraints to buying assets imposed by large minimum denomination size

Services benefitting overall economy

Money supply transmission

- Depository institutions are the conduit through which monetary policy actions impact the rest of the financial system and the economy in general

Credit allocation

- FIs are often viewed as the major, and sometimes only, source of financing for a particular sector of the economy, such as farming and residential real estate.

Intergenerational wealth transfers

- FIs, especially life insurance companies and pension funds, provide savers with the ability to transfer wealth from one generation to the next.

Payment services

- Efficiency with which depository institutions provide payment services directly benefits the economy.

Risks faced by FIs

- Default or credit risk such as loans, stocks and bonds
- Foreign exchange risk
- Sovereign risk
- Interest rate risk due to mismatch of assets and liabilities

Risks faced by FIs

- If FIs actively trade these assets and liabilities rather than hold them for long investments, they are exposed to market risk or asset price risk.
- All FIs are exposed to technology risk and operational risk as they need to use real resources and back office support systems (labor+technology)
- Not having enough capital may lead to insolvency.

Regulation of FIs

- FIs are heavily regulated to protect society at large from market failures

Assignment

- 1. Name 5 investment banks in Saudi Arabia
- 2. Name 5 securities firms in Saudi Arabia
- 3. Describe at least one IPO in terms of number shares offered, offer price, subscription details.
- 4. Name at least one financial institution in the depository and non-depository category.
- 5. Name at least one belonging to each of the categories of FIs.
 - a. Bank

Assignment

- b. Insurance company
- c. Pension fund
- d. Mutual fund
- 6. Number of listed companies in Saudi Arabian stock exchange