Financial system and financial market

24th September 2008

Financial market - introduction

- The financial market can be described as a “magnet” that attracts investors attention to leave there their financial resources represented by savings.
- Investors get rid of current value of financial resources (invest them) because they believe that they will get them back with the premium.
- Premium is reward to their undergone risk.
- Example
  - Investment on 20th September 2008 – 100 USD.
  - On 20th September 2010 investor get 120 USD.
  - Premium – 20 USD
- Motive and fundamental for investment is – the faith of investors that if they invest financial resources the further value of their resources will be higher then the current value.
- BUT there is not guarantee!

Two sides of investment

- In the financial market the investors are divided into two categories.
- The first of them – their investment activities will be successful and the second of them – their investment activities will be unsuccessful.
  - The revenue of the first group depends on how many investors was in the second group and how much they invested.
  - It means that financial market is not possible to beat down.
  - And only thing that wars on the financial market are the groups of investors.

Financial market - introduction

- The financial market plays dominant role in the market oriented economy.
- It is the place where come flows of financial resources from
  - another markets and from
  - different economic subjects.
- It is also the place where are financial resources redistributed on
  - another markets and
  - different economic subjects.

The essence, function and importance of financial market

- Financial market is only one market from the set of markets that exist in the market oriented economy.
- Markets in market oriented economy are following:
  - Goods and services market
  - Labour market
  - Land market
  - Financial market

The essence, function and importance of financial market

- These markets are connected by flows of financial resources.
- On the financial market there are temporary coming financial resources in
  - different value and
  - different time
  - from households, companies and governments and
  - these financial resources are return to them after particular time and under particular conditions.

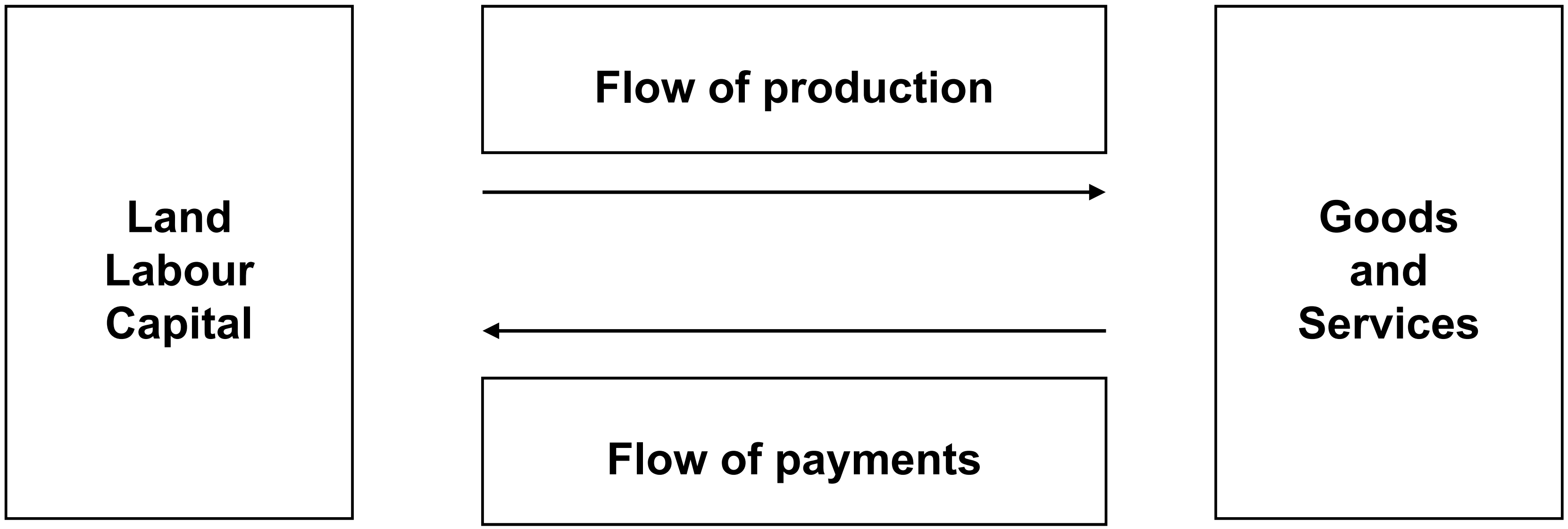
Households

- Offer their labour on the labour market or
- Offer land on the land market
  - Then they in return for get financial resources that they can
    - Invest on the financial market
    - Spend on the market of goods and services

Companies (similar to government)

- Offer their products on the market of goods and services and get sale.
- Spent they money on labour market and pay wage.
- On the financial market they
  - place the surplus financial resources – invest them, or
  - demand free financial resources.

Companies (similar to government)



Main financial market subjects

- On the financial market there are coming in several subjects with different intention.
- Surplus subject
  - This subjects has
    - the surplus of free financial resources
    - They do not have usage for this resources at the moment
    - They have a will to lend them another subject – to invest them.
- These subjects are in the economy the source of savings.
- These subjects are known as a investors or creditors. They are represented by households, companies, security traders, insurance companies, etc.
- Surplus subjects should take into account criteria of revenue, risk and liquidity if they decide about their investment.

Magical triangle of finance

- Risk
- Revenue
- Liquidity
- Possible taxation

Main financial market subjects

- Deficit subjects:
- These subjects have a lack of financial resources.
- Deficit subjects are entering on the financial market to get financial resources and use them to launch own intentions.
- The majority of deficit subjects is represented by issuers (means banks, companies, government that issue securities) or borrowers if they drawdown loan.
- Deficit subjects should take into account criteria of time factor and costs related with financial resources if they decide about their loan of free financial resources.

Main financial market subjects

- The last group on financial market subjects is represented by bank and non-bank financial intermediaries.
- Their role is help in transfer of free financial resources from surplus to deficit market subjects.
- They should limit transactional and informational costs.
- They should also limit risk related with lender-borrower process.
- Intermediaries play connection role between lenders and borrowers and contribute to effective allocation of free financial resources.

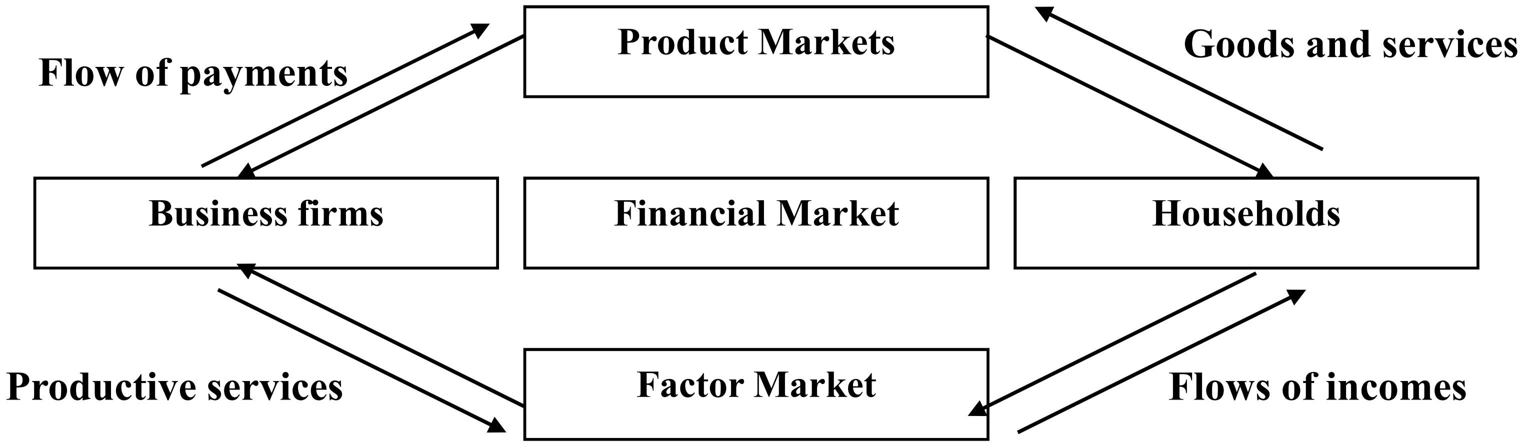
Main financial market subjects

- Bank intermediaries
  - Banks
  - Credits houses, etc.
- Non-bank intermediaries
  - Insurance companies
  - Investment companies
  - Investment funds, etc.

The main role of financial market

- The main role of financial market is
  - managed moving of free financial resources from surplus to deficit subjects.
  - helped to effective usage of all free financial resources in the economy.
  - helped to running of economy

The flow of financial resources in the economy



Effectively on the financial market

- On the financial market there is a possible to get theoretically three kinds of effectiveness.
  - **Allocation effectiveness** – it means that free financial resources should be transfer to the deficit subject that offer the higher revenue with the same level of risk
  - **Operative effectiveness** – it means that transfer of free financial resources should be realize with the lowest transactional costs
  - **Informational effectiveness** – depends on pace of reaction with which is changed the price of financial instruments (stocks) if new information is emerged. The informational effective market is in case that the instruments responds to new information immediately.

Financial market

- Financial market is the set of financial instruments, institutions and relations that causes flow of free financial resources between surplus and deficit subjects.
- Financial market is also market of short and long term securities, financial derivatives, credits and insurance policies.

Investment instrument

- Investment instrument is an asset that gives financial claims to investor.
- This claims has a form of further revenue.
- Revenue can be packaged as
  - Dividends
  - Payments
  - Exchange rate profit
  - Interests, etc.

  Investment instruments can be divided in two groups

    Financial instruments

    Real assets (instruments)

Financial instruments

- This investment tools that do not have a material, concrete form.
  - There are securities, financial derivatives, insurance policies, time and saving accounts, etc.
  - The most typical financial instrument are securities.
  - Generally, securities represent legal claim its owner against the subject that it issued.
  - In some countries (including the Czech Republic) are not securities defined by law and there is only shortlist instruments that are consider to be securities.

Real assets

- This assets have material form, typical examples are investment in precious metal (gold, silver – not consider to be precious metal, platinum, etc.), art collections, estate, etc.
- Why silver is not possible to be precious metal?
  - It is consider to be industrial metal because it is mined as a by-product of copper, zinc.
  - The price of silver depends on business factors and because of its low price it does not have a character the “crisis currency”
  - Silver is also 40 – 50 cheaper than gold.

The functions of the financial market in market oriented economy

- Collection function – all free financial resources are temporary collected on the financial market.
- Allocation function – the financial market cases about transfer of free financial resources from one grout of subjects to another. This transfer is based on criteria of risk, revenue, liquidity. It should term free financial resources in the hand of subjects that offer the higher revenue, together with lower risk and higher liquidity.
- Function of liquidity – financial market cares about trading of financial instruments. On financial market can investor convert its illiquid financial instruments like shares, bonds or certificates to cash.

The functions of the financial market in market oriented economy

- Price making function – on the financial market meet the demand and the supply of particular financial instrument.
- Diversification function – financial market offers possibility of disperse of risk. Diversification means that investors put money in various financial instruments that revenues are not positively correlated.
- Example on 17th September 2008 – sharp decline on the world financial market
  - Dow Jones index: - 4,06 %
  - S & P index: - 4,72 %
  - Nasdaq: - 4,94 %
  - Oil WTI: + 6,08 %
  - Oil Brent: + 5,87 %
  - Gold: + 10,71 %
  - It is evident that gold plays a role of crisis currency and there are opposite trends in price changing of gold and securities.

The functions of the financial market in market oriented economy

- Retain function – the financial instrument are able (some of them better – e.g. real assets some of them worse – securities with fixed revenue) to save purchasing power of investment money against inflation and thus limited impact of inflation on investor
- Depositary function – financial market offer several possibilities where invest resources according to risk, liquidity and anticipate revenue.

Financial market

- If financial market does not exist there will be problems with allocation of free financial resources.
- There was no motivation to borrow or to lend of resources.
- There will be problem with contact between both sides.
- If these sides meet there was not ensure to deliver resources to subject that offer the higher revenue.
- The transfer of resources will be related with high risk and high costs.

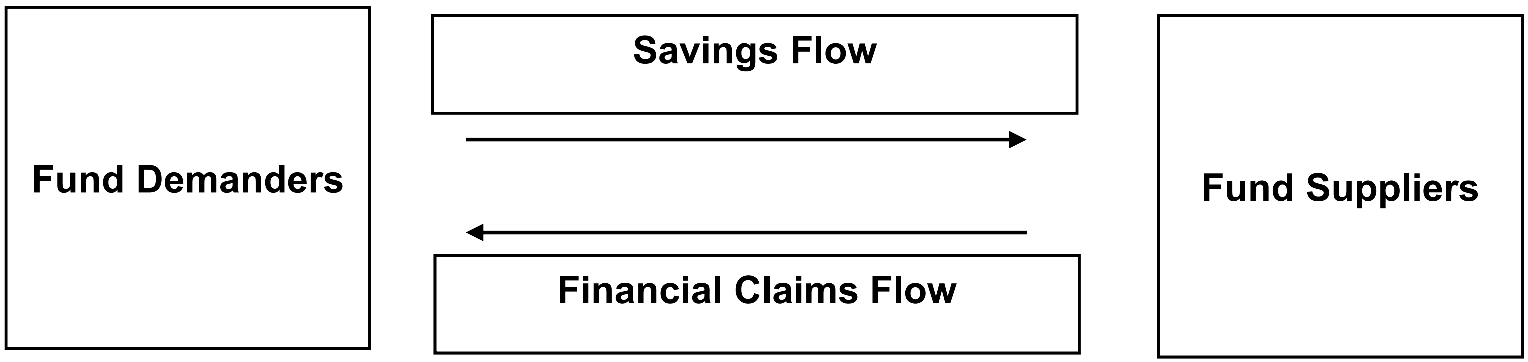
Structure of the financial market

- According to process how are free financial resources allocated
  - Direct allocation
  - Indirect allocation
  - Semi - direct allocation
- According to order of securities sale
  - Primary market
  - Secondary market
- According to financial instrument trading on the market
  - Money market
  - Capital market
  - Foreign exchange market
  - Real asset market

Direct allocation of financial resources

- This allocation is base on direct connection between surplus subject (creditor) and deficit subject (borrower).
- It is the simplest way of free financial resources transfer.
- BUT there is a lot of problems
  - Looking up, contacting and verification of both partners
  - Coordination of requirements and parameters of transaction according to volume, price a time
- Example – borrower issues securities that represents his liability and creditor buys these securities in return for cash.
- Examples of securities
  - Debenture bonds
  - Short term or long term bonds, etc.

Direct allocation of financial resources



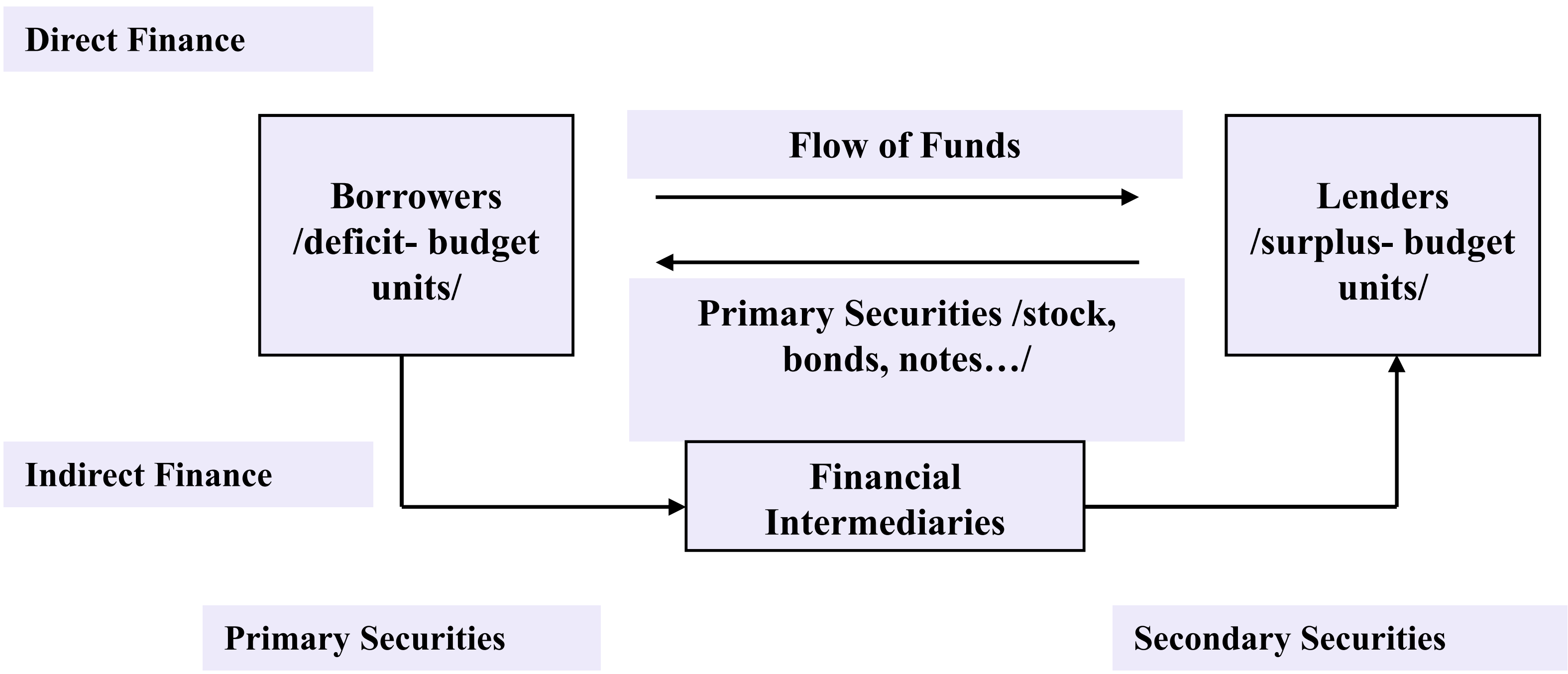
Semi - direct allocation

- It is a halfway between direct and indirect transformation.
- The main goal is limitation of indirect allocation disadvantages.
- The surplus and deficit subjects do not meet personally but use the role of “mediator”.
- The mediator represents the source of information, he is looking for subjects, contact them.
- This allocation is cheaper then direct allocation but there are still disadvantages related with coordination of particular requirements.
- For this allocation is characteristic that on the market are trading only primary investment instruments.

Indirect allocation of financial resources

- The dominant role in this relation play intermediates represented by banks, credits houses, insurance companies, etc. that care about transfer of resources from surplus to deficit subjects.
- From deficit subjects intermediates buy securities (primary securities) and also issue own securities (secondary securities).
- These secondary securities are sold to surplus subjects in return for cash.
- The cash that intermediates get from surplus subjects there are able to buy primary securities from deficit subject.
- Intermediates are based on profit principle.
- The indirect allocation more effective and liquid transfer of financial resources, it is related with lower
  - transactional and informational costs and
  - it limits risk.
- In financial market based on indirect allocation there are primary securities issued by primary issuers (stocks, bonds) and with secondary securities (stocks of unit trusts, investment funds).

Indirect allocation of financial resources



Primary market

- It is market where is primary trading with new issued security.
- Issuer of security gets on this market free financial resources.
- Preparation and execution of issue is done by issuer or are used services of investment bank or security trade. The primary market can be in the form
  - Primary public market – the issue is offer to investment public in the form of tender offer, unofficial market or tender. As the source of information for client there id published Security Prospectus. This kind of issue is called public issue.
  - Primary private market – securities are offered only limited and determined group of investors that have information about issuer financial and economical situation. It means that there is not usually prepared Security Prospectus. Primary owners of security possess this security till the maturity it means that they do not request to trading with particular security on the market. This kind of issue is called private issue and is cheaper then public issue.

Secondary market

- This is market where are trading “old” formerly issued securities that are repeatedly over and over trading.
- This securities are moving form one investor to another.
- The primary issuer of security does not get additional revenue from trading of security.
- Example of secondary market is Stock Exchange that also cares about liquidity of secondary security.
- Secondary market can be in the form of
  - Public secondary market – stock exchange, off-exchange trading, OTC trading or trading with brokers or dealers.
  - Private secondary market – individual trading between interested persons about security and holder of security. It is base on individual conditions.

Secondary market

- Organized market – on this market are trading
  - only licensed subjects
  - under legislation
  - according to rules and directions
  - has form of stock exchange or off-exchange trading
- Open market – on this market there is
  - free entrance on the market
  - trading is not organized by any subject
  - the particular conditions are adjusted by interested persons.
  - This market is also known as a OTC market (over-the-counter).

Financial market according to trade financial instruments

- Money market
  - There are trading short – term investment products with maturity till 1 year
  - Examples – treasure bills, tap CD or bill of exchange
  - There is also trading with short term money between bank subjects through computer network or telephone lines. The price of these short term money is derivate from referential interest rate IBID (Interbank Bid Rate) and IBOR (Interbank Offered Rate).
  - On the money market are at most trading institutional investors and this market is also know as a “wholesale market”
  - For financial instrument is typical
    - Low revenue
    - Low risk
    - High liquidity

Financial market according to trade financial instruments

- Capital market
  - There are trading long – term investment products with maturity from 1 year
  - Examples – stocks, bonds, certificates, financial derivatives – swaps, options, futures.
  - The role of surplus subject is played by banks, insurance companies, investment banks, etc.
  - The risk, liquidity and revenue are different for every particular product but generally if we compare with money market there is
    - Higher revenue
    - Higher risk

Financial market according to trade financial instruments

- Foreign exchange market
  - There is trading with liabilities in foreign exchange.
  - Usually this market has a form of open market with high liquidity, effectiveness and competition.

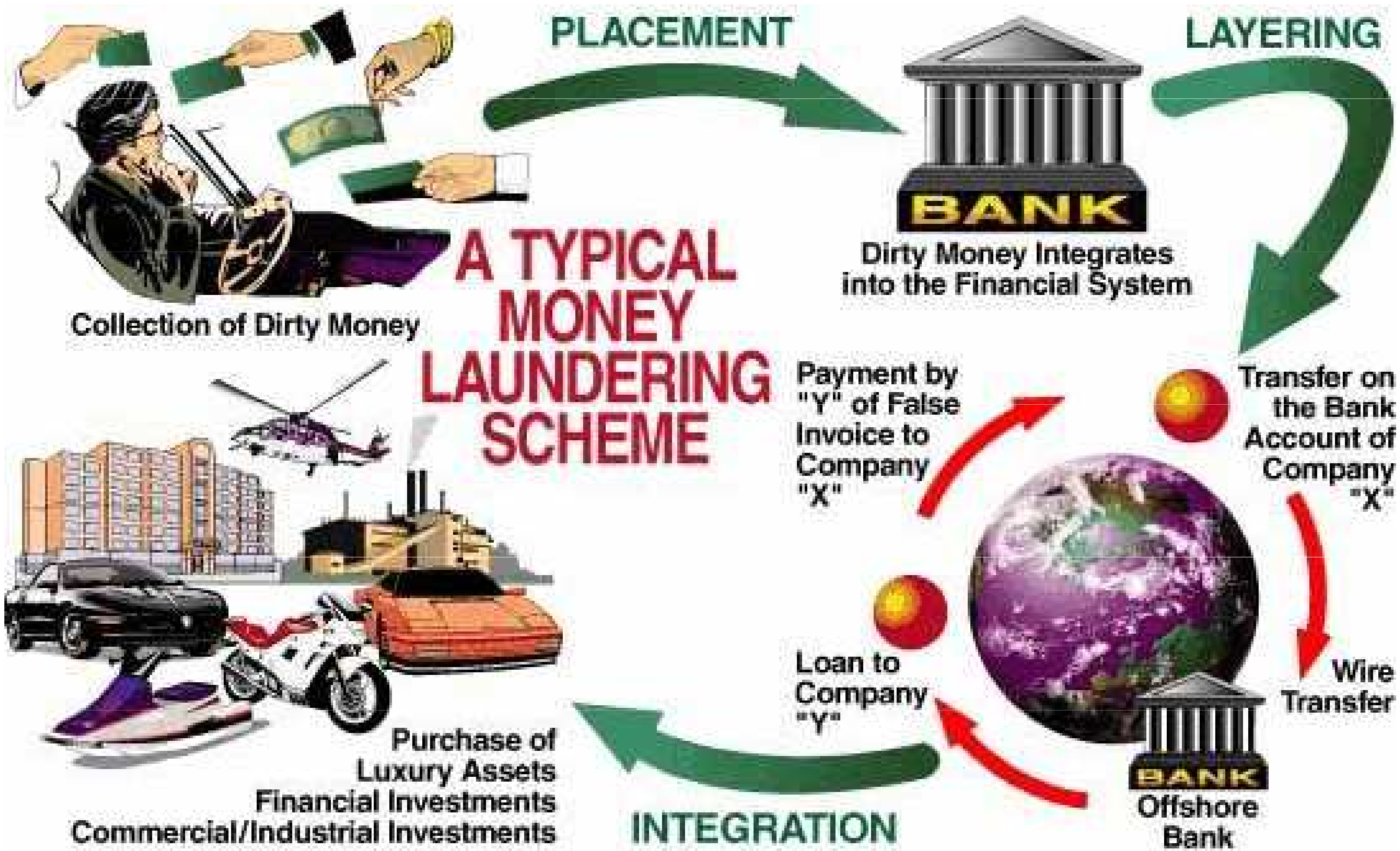
- Real asset market
  - There is a trading with financial instruments that are related with particular thing.
  - Example gold or silver ingot, coins, stocks of goldmine, etc.
  - Between change of particular real asset value and e.g. inflation there can be negative correlation. It means that in time of uncertainty the interest about this instrument is growing.
  - Nowadays the role of these market is not so significant as a role of capital or foreign exchange market.

Illegal activities on the financial market

- Money laundering
- Insider trading
- Data handling
- Intentionally harm of investors
- Other illegal activities

Money laundering

- The aim is to do a lot of neutral activities with money from illegal activities to appear that the money come from legal activities or from business.
- The main goal is to seek origin of money.
- This term was first used in 1973 and it is related with affair Watergate.
- The financial institutions have several banking rules against money laundering
  - Identification of banking transaction participants
  - Announce unusual transaction, etc.



PLACEMENT
LAYERING
BANK
Dirty Money Integrates into the Financial System
A TYPICAL MONEY LAUNDERING SCHEME
Collection of Dirty Money
Payment by "Y" of False Invoice to Company "X"
Transfer on the Bank Account of Company "X"
Wire Transfer
Loan to Company "Y"
BANK
Offshore Bank
Purchase of Luxury Assets
Financial Investments
Commercial/Industrial Investments
INTEGRATION

Insider trading

- It is trading with internal or private information.
- Usually
  - primary insider that has information from employee relation or
  - secondary insider that buys private information
  - is trading with securities using important private information about prepared important changing in bid or offer price. But this information are not accessible to investment public.
  - The insider buy or sell securities before important change in the value of securities.

Data handling

- It is an effort of particular subject to misrepresent of idea about bit or offer price, supply or demand of particular financial instrument.
- Data handling is realized by
  - Through illegal trading units – pools
  - Through “corneringu” it means concentrate of securities in the hands of limited group of people
  - Through creating of false market – where happened causeless bid changes base on false, pretended or tricky information.

Intentional harm of investor

- Churnings – brokers that want to maximalist fees give worthless bet to clients.
- Abuse of clients if there is accounted the higher (in case of buy) or lower (in case of sale) price to client.
- Recommendation of security trader to buy overestimated financial instrument because it is profitable for trader portfolio.
- Recommendation or consultancy through phone that is worthless or abuse of confidence of investors.

Thank you for your attention

Questions?