Instructor: So, what we're gonna do today, is we're gonna start a bit looking at things conceptually, a little bit. So, get the concepts today about what these different organizations are about. Also, we'll be looking at some basic things about financial markets, different types of financial markets. So, there's the primary market, the secondary market, and we'll also be looking at some of the securities that they issue.

Instructor: What do they do, the financial intermediary? Well, it takes its money from the people that have got excess cash, and they lend it to those who want to borrow that cash, basically. They're deficit agents, as we call them. So, that's what it's all about is basically taking that money from those that have got the surplus money, and transfer it to those that actually need it.

Instructor: So, everybody's got their different motives. You see. That is very important. It's the same with the people with the excess cash. What we call the surplus people that have earned more that they can spend. They wanna save money, and maybe get a return on that money, but they're a very diverse bunch. That means, of course, this is the important thing, is that there's plenty of space for specialism, here.

Instructor: Obviously, it's risky. The people that wanna borrow money, they're always a risk, normally. Will someone who takes out money for their mortgage pay you back? Yeah, that's risky. Companies, they invest a lot. Are they guaranteed a return? Absolutely not. So, risk is one thing that these deficit agents, and obviously, financial intermediaries need to be clever. They have to try to keep those risks down.

Instructor: So, you've got a lot of screening, and you've got a risk management techniques. You're not just gonna lend to one company, if you're a bank. That's highly risky. So, financial security, and there's various types, they vary a lot, because there's always different crowds. Some people are prepared to take more risk, than others. So, there's surplus agents, those ones with the cash, those companies, or individuals, we need to attract them to invest in our products.

Instructor: So, governments issue a security, what do they do? They borrow money. What do they do? They issue a treasury bond. It might be five, 10, and people will invest in it. Now, what are they getting, in that case? Most of the time, you get a fixed rate of interest. If you buy it, they might say, "Invest 100 pounds in a UK treasury bond. We'll give you five pound a year, for five years. Then, we're gonna give you you're 100 back." You're likely to get your money back, in that case. So, that's a pretty safe security.

Instructor: So, securities vary. Fundamental to finance are these two securities, debt and equity. So, what is debt? Well, it's very important that you get this. If I'm issuing debt, as a company, why do people buy that? Well, they know they're going to get some coupons, every year. They're gonna get some interest payable to them, and corporations issue it. Not always is that interest fixed, of course. Some things, you know what you're gonna get, and others, like the floating rate note, you don't know, but obviously you hope that over the lifespan you'll get a reasonable return.

Instructor: What's the of the most important thing about debt, if I buy debt in a company is that I'm ahead of the equity holders. So, if that company goes bankrupt, guess what? I'm still gonna get some money back. The equity holders are probably gonna be wiped out. This is a very important part of finance theory is that the debt holder, you've got more safety. That doesn't mean you're safe. You're never safe, but if that company was to go into bankruptcy, guess what? You're right at the front of the queue. They call that the recovery rate. What percentage will you get back? It sort of averages about 40%. Sometimes you get back 80, 90. Others you might only get 10% back.

Instructor: The equity holders, what have they got? They've got a share in the company. The thing is I'm an owner of the company. The important thing is I'm not guaranteed any payments, whatsoever. I might get dividends. If you're an equity holder, it's a different ballgame. You own the company.

Instructor: Now, institutions also own shares, on behalf of the people that invested in them. So, a mutual fund, they're taking the money, they're put it into shares. The thing is, you've got no guarantees about your return, here. You're hoping of that capital appreciation. You hope that you buy that share at $100, and it goes to $300, great. You're also hoping for dividends, somewhere along the line.

Instructor: Many companies, actually, when they issue these shares, they don't pay dividends for a number of years, 'cause the argument is it doesn't always work out, of course, that they would expand the company rapidly. Now, the great thing is about equity finance is you don't have to pay anything. So, this is a fundamental part of the capitalist system is we distinguish legally between those debt holders, and those equity holders. They're creditors. They're owners. If you can remember those two basic differences, that's probably one of the most important things.

Instructor: It sounds a bit academic. We basically classify financial instruments using this table. You don't really need to know, which is type one, two, three, and four, but the thing is that some liabilities that we issue, some securities that we issue, you know how much you've got to pay out, and you also know when you're gonna pay it. We'll call it type one. Can anyone think of a security that's issued that the investors know, when they're gonna get their pay out, and the amount. They also know when they're gonna get it? Anyone?

Student: [inaudible 00:05:26]

Instructor: Pardon?

Student: [inaudible 00:05:29] government bonds.

Instructor: Government bond. They basically say, "I'm borrowing for five years." You're gonna get these coupons every year. Then, right at the end, you're gonna get your principal back. Basically, that's it. They know which one they've picked. They know when they're gonna get the payments. They know the amount. It's pretty clear to them.

Instructor: What about type two? Now, you know the amount of the liability, but the timing is not so clear. A product like that. So, I've issued something. I'm guaranteeing you some payments. I know how much I'm gonna pay you, but I don't know, when I'm going to pay you.

Instructor: There is one, life insurance. A life assurance. We all know we're going to die. So, I can take out a policy that's gonna pay me my wife 300,000, when I die. That's clearly written. I don't know when I'm gonna die. That's a type two. The insurance company that issues that assurance policy, that's what they're doing.

Instructor: What about a type three? This is an interesting one. You don't know the amount of the liability, but you might know the timing of it. So, you know you're gonna have to pay an amount, but you don't know what the amount will be. The floating rate note will fall under that one, because it depends what's happened to libel. If libel's gone up, then I've got to pay you more. We know that every ... at the end of the year, or whenever it is, I've got to pay you a certain amount. The floating rate note is a classic one.

Instructor: The final one, you don't know either. You've got no idea of the amount of liability, and you don't know the timing. Insurance is the classic one. Say I'm selling you a car insurance policy. You have an accident in a crash. I don't know when you're going to have a crash, and I don't know the amount. There's uncertainty.

Instructor: So, what I'm saying is, of course, lots of financial intermediaries might cover two or three of these areas. Some of them just specialize in one. So, I've got a few examples there. We've got a lot of variety, in the market. There's all those different surplus, deficit agents. They've all got their different needs. So, this is why we've got all this enormous variety in finance.

Instructor: Particularly in the UK, we've got a very developed financial system. As do the Americans, and of course, we sell these products around the world, as well. Remember that also, about the customers. They're from all over the world. When I'm selling my UK treasury bond, I'm not just selling it to British citizens. We're very happy to sell to the Chinese government, the Americans.

Instructor: Did you know, something like 30% of US treasury bonds are actually sold to the Chinese government. The Chinese government is sort of funding capitalist America. I love that one. So, not just your domestic base, of clients out there. A lot of these financial intermediaries, it's absolutely pivotal that they're selling to international.

Instructor: So, what do financial intermediaries do? One of the key things is transferring these funds. It's probably the most important thing they do, but one could dispute that, but it's absolutely fundamental to the successful operation of an economy. We need to get those two parties some transfer of funds between them. Of course, people criticize people in the world of finance, but they're actually an important part of the capitalist economy, full stop.

Instructor: It's very important that the people that are lending that money, that they've got trust in that system. I can't emphasize enough the second the trust goes, you're out of business, basically. It's pretty much that. It's very important that both sides can trust that intermediary. Especially, the surplus people, 'cause they've got their money at stake.

Instructor: This is very important, as well. Maturity transformation. What does that mean? Well, I'll give you a simple example. When we put money in our banks, we often wanna be able to drag it out quickly, if we need to. So, banks have got a lot of this short term money coming in. There are people prepared to pull it out, lock it into an account for two years. That's fine. They get a high rate of interest, of course, but what do banks mainly then do? They tend to lend out medium and long term.

Instructor: People want a mortgage. Okay. I'll lend you money for 25 years. Oh, you want a car loan, do you? Okay, that's a five year car loan. You see? This is what we mean by maturity transformation. You've got your liabilities. If you're on the bank they're those deposits. People want liquidity. They want to be able to access. Sometimes, you've got to give them certain amount of days notice, but by and large most of us just like the ability to take it out straight away.

Instructor: So, a lot of short term liabilities, but they're assets, one of their assets, they're loans basically. Those loans are medium to long term. Now, some of them are short term, as well. So, actually, this is very important, you see? If you've got those surplus people want liquidity. They want to be able to withdraw their money at short notice. You've got the borrowers, the deficit agents, as we like to call them. They need to borrow longer term. They don't want to be suddenly ...

Instructor: You can see there'd be a problem with those two. How you gonna meet? I want my money back short term. You want it long term. We've got a problem on our hands, you see? This is where the banks step in. So, we call these maturity transformation. It's very important.

Instructor: Risk transformation. Again, you'd have a real problem. One of you wants to borrow off me. I don't know anything. By the way, we call this asymmetric information problem. So, think of a bank. I'm gonna lend someone some money. I've got no idea, if they intend to pay me back or not. Some of them do.

Instructor: So, the customer knows whether they intend to pay me back. Some of them don't. Again, this is where the banks step in a little bit. They try to screen out the bad ones. The people that either won't pay you back, or won't be able to pay you back. That's called credit screening. That risk, which would be very high, I haven't got time to check your credit history. It'd be very expensive, as well, time consuming, meet you, have a coffee with you. It's just not gonna happen. So, the banks are doing a very good role, in that sense. They're trying to screen out the bad risks, not all of them. They're gonna take some risks, of course, but they know they've got a whole portfolio of borrowers that some will get into trouble, but hopefully the others will pay them back. They can factor that into their loan rates, and things like that. We just haven't got the time. So, we just leave it to the banks, and hope that they will do it.

Instructor: Financial markets. They're all types of financial markets out there. Some of these things mature. So, maturity is very important in these different markets. That's the difference, which I mentioned before about equity, capital markets, and money markets. Money markets are short term. Things mature shortly. A three month treasury bill, it'll mature in three months, and you get your money back, but other things mature much later, much longer.

Instructor: Now, markets also differ in their structures. The foreign exchange market is extremely sophisticated. It's a global 24, seven market, basically. Liquidity is better at certain times of the day, when New York's open, and London, but it's still pretty a liquid market, all the time. Some markets only trade for a few hours per day. Commodity markets, London Fix, there's about an hour of frantic trading and that's basically the fix. That doesn't mean there's not trading electronically, as well.

Instructor: Markets change, over time, in their structures. The move to electronic, it's just so much better. I can see the quantities, this that, but some of them, even in the foreign exchange market, it's not all done by the computer. On the big deals, you still get on the phone. 50 million dollars, you want to buy 50, you've still got to get on the phone.

Instructor: Markets, they vary in their organization structure. One thing you can always say, "The only constant is change," in a financial system. Obviously brokers, from the foreign exchange market, if I'm gonna buy currency, I want the best possible rate. If I'm gonna buy 10 million dollars, if I get 150 to the pound, versus 150 point zero, zero, one, doesn't sound a lot, but it's a lot of money, when I'm doing 10 million. For one pound it's virtually no difference, but you do that, and that can be 1,000 pound difference.

Instructor: So, institutional clients are very sensitive to get the best rates. Brokers to keep them screened, so they automatically give them the best rates, at any second on their screen. There's thousands of people wanting to sell you dollars, but they'll always give you the very best one. If you're trying to buy pounds, you obviously want to give them as few dollars, as possible. There's lots of people; they'll give you those pounds. You don't want to pay too much for them, if you're trying to get out the dollar due. The bid offer spread, keeping it down, is very important.

Instructor: A lot of financial intermediaries, when they sell you their products, they also make a market in them. So, if I'm issuing a corporate bond, might been issued by Goldman-Sachs, UBS. They help the company issue it, but they become market makers. You need that secondary market. That's the job of market makers.

Instructor: Markets are full of all sorts of people. Some of them are arbitrageurs. They're basically trying to exploit price differences. If I can get it for 100, and sell it somewhere else for 101, that's an arbitrageur. Riskless guaranteed profits. Hedgers, they're buying products to reduce risk. That's what hedging's all about. Speculators, they're all over the place. They're people like me, betting on things going up or down. People are buying things just sometimes, just for ten seconds, these days. Computerized trading. Many American shares are held for less than an hour. The vast majority of them are now algorithmic trading is taking over. Sometimes just buying things and selling them later, but they're helping to exploit the price difference, between what they're bought and sold at.