

CHAPTER 2

FINANCIAL ASSETS, FINANCIAL TRANSACTION AND FINANCIAL INTERMEDIATION

2.1 The creation of financial assets

Asset: - Any possession that has value in an exchange. Anything of value that is owned or controlled by a business/ individual.

A. Financial Assets/Instruments vs Physical Assets

1. Physical assets

Physical assets have a physical characteristics or location such as buildings, equipment, inventories etc. Physical assets provide continuous stream of services. Physical assets wear out or subject to depreciation. Their physical condition is relevant for the determination of market value

2. Financial assets

A financial asset is a liquid asset that gets its value from a contractual claim. Cash, stocks, bonds, bank deposits and the like are examples of financial assets. Unlike land, property, commodities, or other tangible physical assets, financial assets do not necessarily have inherent physical worth. They are usually created by or related to the lending of money (credit transactions). Example: - Stocks, Bonds, Insurance policies, Deposits held in a commercial bank, credit union or saving banks.

2.2 Characteristics of financial assets

- a. Financial assets do not provide a continuous stream of services to the owners i.e. promise future returns to their owners
- b. Financial assets serve as a store of value i.e. purchasing power
- c. Financial assets cannot be depreciated physically i.e. do not wear out
- d. The physical condition of financial assets is irrelevant in determining the market value or price
- e. The cost of transporting and storing financial assets is low

2.3 Kinds of financial assets

Financial assets can be classified in to two categories:

-  cash instruments and
-  derivative instruments:

a. Cash instruments

Cash instruments are instruments whose values are determined by the markets. They include instruments like:

- ❖ Money (coins, currency, and checks)
- ❖ Bonds,
- ❖ Common stock, preferred stock,
- ❖ Treasury bill,

- ❖ Commercial paper,
- ❖ Promissory notes
- ❖ Bankers' acceptances
- ❖ Life insurance policies
- ❖ Certificate of deposits
- ❖ Repurchase agreements (repos)

1. Treasury-Bills (T-Bills)

Treasury bills (or T-bills) mature in one year or less. They are debt securities. They do not pay interest prior to maturity; instead they are sold at a discount of the par value to create a positive yield to maturity. Many regard Treasury bills as the least risky investment available to investors.

Regular weekly T-Bills are commonly issued with maturity dates of 28 days (or 4 weeks, about a month), 91 days (or 13 weeks, about 3 months), and 182 days (or 26 weeks, about 6 months). Treasury Bills are sold by single price auctions held weekly. Banks and financial institutions, especially primary dealers, are the largest purchasers of T-Bills. Treasury bills are quoted for purchase and sale in the secondary market on an annualized percentage yield to maturity, or basis.

2. Commercial paper

Commercial paper is a market security issued by large banks and corporations. It is generally not used to finance long-term investments but rather to purchase inventory or to manage working capital. It is commonly bought by money funds (the issuing amounts are often too high for individual investors), and is generally regarded as a very safe investment. As a relatively low-risk investment, commercial paper returns are not large..

3. Certificate of deposit

A *certificate of deposit* or *CD* is a time deposit, a financial product commonly offered to consumers by banks, thrift institutions, and credit unions. Such CDs are similar to savings accounts in that they are insured and thus virtually risk-free; they are "money in the bank". They are different from savings accounts in that the CD has a specific, fixed term (often three months, six months, or one to five years), and, usually, a fixed interest rate. It is intended that the CD be held until maturity, at which time the money may be withdrawn together with the accrued interest.

In exchange for keeping the money on deposit for the agreed-on term, institutions usually grant higher interest rates than they do on accounts from which money may be withdrawn on demand. Fixed rates are common, but some institutions offer CDs with various forms of variable rates. These allow for a single readjustment of the interest rate, at a time of the consumer's choosing, during the term of the CD. A few general rules of thumb for interest rates are:

- A larger principal should receive a higher interest rate, but may not.
- A longer term may or may not receive a higher interest rate, depending on the current yield curve.
- Smaller institutions tend to offer higher interest rates than larger ones.
- Personal CD accounts generally receive higher interest rates than business CD accounts.

Key terms and conditions of a certificate of deposit include:

- The CD may be "callable." The terms may state that the bank or credit union can close the CD before the term ends.
- Payment of interest. Interest may be paid out as it is accrued or it may accumulate in the CD.
- Interest calculation. The CD may start earning interest from the date of deposit or from the start of the next month or quarter.
- Right to delay withdrawals. Institutions generally have the right to delay withdrawals for a specified period to stop a bank run.
- Withdrawal of principal. May be at the discretion of the financial institution. Withdrawal of principal below a certain minimum—or any withdrawal of principal at all—may require closure of the entire CD
- Withdrawal of interest. May be limited to the most recent interest payment or allow for withdrawal of accumulated total interest since the CD was opened. Interest may be calculated to date of withdrawal or through the end of the last month or last quarter.
- Penalty for early withdrawal. May be measured in months of interest, may be calculated to be equal to the institution's current cost of replacing the money, or may use another formula. May or may not reduce the principal—for example, if principal is withdrawn three months after opening a CD with a six-month penalty.
- Fees. A fee may be specified for withdrawal or closure or for providing a certified check.
- Automatic renewal. The institution may or may not commit to send a notice before automatic rollover at CD maturity. The institution may specify a grace period before automatically rolling over the CD to a new CD at maturity.

4. Repurchase agreement

Repurchase agreements (RPs or repos) are financial instruments used in the money markets and capital markets. A more accurate and descriptive term is Sale and Repurchase Agreement, since what occurs is that the cash receiver (borrower/seller) sells securities to the cash provider (lender/buyer) now in return for cash, and agrees

to repurchase those securities from the buyer for a greater sum of cash at some later date, that greater sum being all of the cash lent and some extra cash (constituting interest, known as the repo rate).

A reverse repo is simply the same repurchase agreement as described from the buyer's viewpoint, not the seller's. Hence, the seller executing the transaction would describe it as a 'repo', while the buyer in the same transaction would describe it a 'reverse repo'. So 'repo' and 'reverse repo' are exactly the same kind of transaction, just described from opposite viewpoints.

5. Bankers Acceptance

A banker's acceptance, or BA, is a time draft drawn on and accepted by a bank. Before acceptance, the draft is not an obligation of the bank; it is merely an order by the drawer to the bank to pay a specified sum of money on a specified date to a named person or to the bearer of the draft. Upon acceptance, which occurs when an authorized bank accepts and signs it, the draft becomes a primary and unconditional liability of the bank. If the bank is well known and enjoys a good reputation, the accepted draft may be readily sold in an active market. A banker's acceptance is also a money market instrument – a short-term discount instrument that usually arises in the course of international trade.

b. Derivative instruments

Derivative instruments derive value from some other instruments. They include instruments like options, bond futures, warranties, swaps etc.

Financial assets can also be classified as debt securities and equity securities.

i. Debt securities

Debt securities are securities in which the borrower agrees to pay periodic interest and principal. They may be issued by Corporations, Financial Institutions, or Governments. Debt securities include securities like:

- ❖ bonds
- ❖ treasury bill
- ❖ commercial paper
- ❖ promissory notes
- ❖ bankers' acceptances
- ❖ life insurance policies
- ❖ certificate of deposits
- ❖ repurchase agreements (Repos)

ii. Equity securities

Equity securities represent ownership in a business firm. They are claims against the firm's profits and proceeds from the sale of its assets upon liquidation. They usually include

- ❖ Common stock and
- ❖ Preferred stock.

Financial assets can be further classified as negotiable and non-negotiable instruments.

1. Negotiable Instruments

Negotiable instruments are securities that can be easily transferred from one holder to another. Their claims are paid to the bearer of the instrument. They may be classified in to payable to order, and payable to bearer. An instrument is said to be payable to order if it is transferred to another party by endorsement at the back of the instrument. On the other hand, an instrument is said to be payable to bearer if it is transferred to another party by delivery. Negotiable instruments include instruments like bonds, checks, stock, treasury bill, etc

2. Non-negotiable Instruments

Non-negotiable instruments are securities that cannot legally be transferred from one party to another party. They include instruments like:

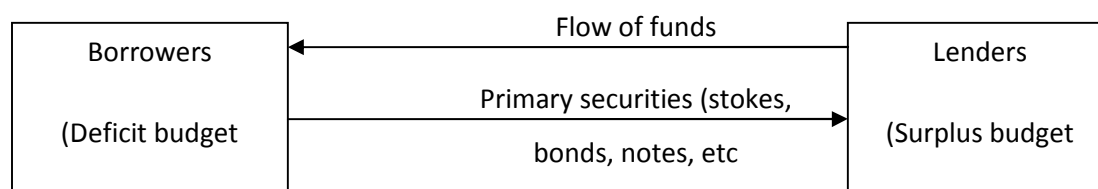
- saving accounts
- bill of lading
- air waybill
- crossed check (a crossed check can only be deposited in a bank-account and, unlike a bearer check, cannot be cashed over a bank's counter)
- warehouse receipts
- letter of credit, etc

2.4. Types of financial transactions

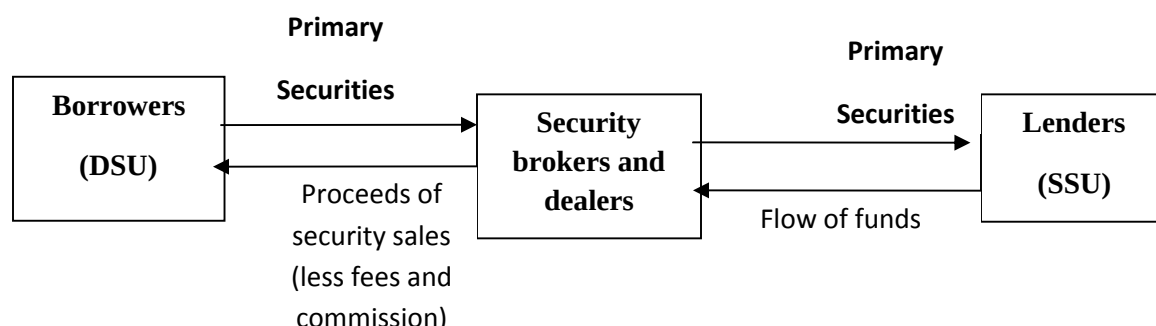
All financial systems perform at least one basic function. They move scarce funds from those who save and lend (surplus-budget units) to those who wish to borrow and invest (deficit-budget units). In the process, money is exchanged for financial assets however the transfer of funds from savers to borrowers can be accomplished in at least three different ways. These are:-Direct finance, Semi-direct finance, and Indirect finance.

1) Direct Finance

Borrower and lender meet each other and exchange funds in return for financial assets. It is the simplest method of carrying financial transactions. You engage in direct finance when you borrow money from a friend and give him or her IOU (a promise to pay) or when you purchase stocks or bonds directly from the company issuing them. We usually call the claims arising from direct finance primary securities because they flow directly from the lender to be ultimate user of funds.



2) Semi direct Finance



There are Financial Institutions which do not act as Financial Intermediaries. They are financial institutions which facilitates funds transfers from SSUs to DSUs without creating securities on their own. They simply act as conduit pipe between the SSUs and DSUs.

For example, a **security** broker in **Bole addis** may provide the services of procuring shares offered by a newly formed Share Company to an investor situated in DZ, for a commission or service charge.

In this context, the security broker does not create a secondary security (like the one created by financial intermediaries), but simply transfers the security of the DSU (the share company) to the SSU (the investor in DZ). This kind of financial transaction is known as '**Semi-Direct Finance**', which is facilitated by 'Financial Institutions which are not financial intermediaries'.

Broker

- o An individual or institution that provides information concerning possible purchases and sales of securities
- o Either a buyer or a seller of securities may contact a broker, whose job is simply to bring buyers and sellers together.

☞ Dealer

- Also serves as a middle man between buyers and sellers, but the dealer actually acquires the seller's securities in the hope of marketing them at a more favorable price.
- Dealers take a position of risk because by purchasing securities outright for their own portfolios, they are subject to risk of loss if those securities decline in value.

Advantages of semi direct finance over direct finance

- It lowers the search (information) costs for participants in the financial markets. Frequently, a dealer will split up a large issue primary securities into smaller units of affordable by even buyer of modest means and there by expand the flow of savings into investment.
- Broker and dealers facilitate the development and growth of secondary markets where securities can be offered for resale.

Drawback of semi direct finance

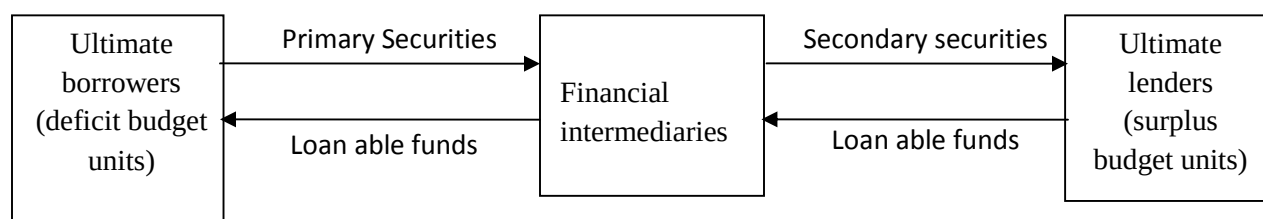
The ultimate lender still winds up holding the borrower's securities and therefore, the lender must be willing to accept the risk, liquidity and maturity characteristic of the borrower's IOU.

☞ This still must be a fundamental coincidence of wants deficit – budget units for semi direct financial transactions to take place.

3) Indirect Finance/Financial Intermediation

The limitations of both direct and semi direct finance stimulated the development of indirect finance carried out with the help of financial intermediaries.

The financial intermediaries obtain the funds from the SSUs and offer their own securities (such as Deposit Certificates, Insurance Contracts, and Pension Contracts, which are commonly known as **Secondary Securities**) as financial claims to the SSUs. They then provide the funds to the DSUs (in the form of advances) and accept the securities issued by DSUs (such as Stocks and Shares, Bonds and Debentures, Treasury Bills, which are widely known as **Primary Securities**) as financial claims on the DSUs. Thus they carry out '**financial intermediation**'.



Examples of such securities include: checking and saving accounts, health, life and accident insurance policies, retirement plan and shares in mutual fund.

- 1) They generally carry low risk of default
- 2) The majority can be acquired in small denominations

- 3) They are liquid (for most) and can be easily converted into cash with little risk of significant loss for the purchaser.

Major groups of Financial Intermediaries are

⇒ Depository Institutions:

Commercial banks

Non-bank thrifts:

- S and L associations
- Savings banks
- Credit unions
- Money market funds

⇒ Contractual institutions:

- Life insurance Company's
- Property – causality insurers
- Pension funds

⇒ Investment Institutions:

- Investment Company's (mutual funds)
- Real-estate investment trusts.

⇒ Other Financial Intermediaries:

- Financial companies
- Government credit units