Corporate finance and capital markets
Paola De Vincentiis, 29 September 2017
Orientation day
Introduction, basic concepts and terminology
Overview of the financial system

Regulation

Financial instruments

Financial intermediaries

Financial markets
Financial intermediaries

- Banks
- Insurance companies
- Investment companies
- Mutual funds
- Pension funds
Financial markets

- Money market
- Bond market
- Forex market
- Stock market
- Derivatives market
Financial instruments

- Stocks
- Bonds
- Mortgage loans
- Consumer loans
- Credit cards
- Life insurances
- Floating rate notes
- Stock index futures
- Credit default swaps
Functions of the financial system

- Transfers money from those who have a surplus of funds to those who have a shortage of funds (time transfer).

- Provides instruments to perform payments (space transfer).

- Provides instruments to reduce the exposure to risks (and thus the uncertainty concerning future financial cash flows).
Surplus/Deficit = Income – Consumption – Investment in durable goods

Saving = Income – Consumption

Surplus/Deficit = Saving – Investment in durable goods

Example:

In 2014 Mario cashed salaries for 70,000 euro and a rent for 10,000 euro. He spent 55,000 in food, cloths and leisure. He spent 25,000 euro to buy a new car and 35,000 euro for a garage.

Calculate Mario’s surplus/deficit in 2014.
Economic actors: typical position in terms of deficit/surplus

<table>
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<tr>
<th>Type of economic actor</th>
<th>Typical revenues and costs</th>
<th>Most common sign</th>
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| Individuals, families  | **Income**: salaries  
                        | **Consumption**: food, dressing, leisure | + |
| Non-financial corporates | **Income**: revenues from sales  
                        | **Consumption**: production costs and administrative costs | - |
| Public entities        | **Income**: taxes, fees for public services  
                        | **Consumption**: production costs and administrative costs | - |
Direct finance vs. Indirect finance

- Lenders/savers transfer money directly to borrowers/spenders through instruments negotiated in a financial market.
- A financial intermediary may be involved in a facilitating role, but does not participate in the fund transfer.
- If involved, the financial intermediary earns a fee.
- A financial intermediary (typically a bank) borrows from those who are in surplus in order to lend money to those who are in deficit.
- The financial intermediary takes part directly in the transfer and the transaction affects its balance sheet.
- The financial intermediary earns an interest margin.
Structure of financial markets

- Debt Market vs. Equity Markets
- Capital Market vs. Money Market
- Primary Market vs. Secondary Market
- Regulated vs. Over-the-Counter Market
Why do financial intermediaries exist?

- Transaction costs
- Divergence of preferences
- Asymmetries of information
Transaction costs

- Search for adequate information
- Analysis of the information and comparison of potential counterparts
- Legal and procedural costs related to contract preparation
- Monitoring of counterpart’s behaviour during the operation

Intermediaries can minimise the percentage weight of these costs thanks to economies of scale
Divergence of preferences

Financial intermediaries help in solving the problem through:

- Term transformation
- Risk transformation

Borrow short and lend long
Asymmetries of information

Borrowers always have more information than lenders. This generates two potential phenomena:

- Adverse selection
- Moral hazard
A world without banks

The New York Times

I’ve been sympathetic to the Occupy Wall Street movement, but, look, finance is not evil. Banking has contributed immensely...

YOUR MONEY
CAPITALISM: ON TRIAL
What do banks do for you?