KAPLAN

PBE

December 2007 Diet

Paper 3 Financial Management

Stanley Lau

Agenda of Today

- ***Who am I***
- ***Introduction to the Paper***
- ***Presentation Schedule***
- ***Examination Trends and Analysis***
- ***Lecture One***

Who am I - Stanley Lau BBA,MAIA,ACS,ACIS,ATIHK,AAIA,CPA (HK)

- ***Subject matter specialist in Financial Management and Financial Reporting***
- ***Extensive practical experience in different industry sectors***
- ***Extensive teaching experience in the higher education sector***
- ***Currently employed as Chief Financial Officer in company listed in the Mainboard of Singapore Ex.***

Workshop facilitator and Marker for HKICPA Qualifying Program for many Years.

Paper III Financial Management

Aim of the Paper - Introduction

"Students are expected to have an understanding of the different core areas of financial management likely to be encountered in the working environments. This includes understanding the *financial implications of organisational choices, policies and environment, managing financial risks and assessing financing choices*. ***This also includes*** *statistical techniques* ***for analysing and presenting business information, and a basic understanding of*** *macro and micro economics*.***"***

Paper III Financial Management

Format of the exam

Section A ***: 2 compulsory questions*** ***40%***

Section B ***: 3 (out of 4) questions***

of 20 marks each ***60%***

100%

Paper III Financial Management

Syllabus content

Part 1 – Financial Management (Weighting 70%)

1) Understand the financial implications of organisational choices

- *Scope of financial management*
- *Alternative forms of business organisations*
- *Goals of corporate firms*
- *Agency problems*

Paper III Financial Management

Syllabus content

Part 1 – Financial Management (Weighting 70%)

2) Understand the financial implications of organisational environment

- *Financial and capital markets in Hong Kong and overseas*
- *Consumption choices over time*
- *Consumption choices with investment opportunities*

Paper III Financial Management

Syllabus content

Part 1 – Financial Management (Weighting 70%)

3) Calculate and value bonds and stocks

- *Interest rates and bond prices*
- *Yield to maturity*
- *Dividend-growth models of stock valuations*

Paper III Financial Management

Syllabus content

Part 1 – Financial Management (Weighting 70%)

4) Understand the concept of financial risks in investment portfolios

- *Definitions and measures of risk*
- *Return and risk for individual securities*
- *Return and risk for portfolios*
- *Efficient sets*
- *Market equilibrium: The Capital-Asset-Pricing-Model (CAPM)*

Paper III Financial Management

Part 1 – Financial Management (Weighting 70%)

5) Manage an organisation's financial operation

- *The Net Present Value (NPV) rule*
- *The basics of capital budgeting*
- *Some alternatives to NPV and their problems*
- *The use of the NPV rule: Incremental cash flows*
- *Inflation and capital budgeting*
- *Investments of unequal lives*

Paper III Financial Management

Syllabus content

Part 1 – Financial Management (Weighting 70%)

6) Manage financial risks in organisations

- *Risk and the cost of equity capital*
- *Estimation of systematic risk (Beta)*
- *Determinants of systematic risk*
- *Weighted average cost of capital (WACC)*

Paper III Financial Management

Syllabus content

Part 1 – Financial Management (Weighting 70%)

7) Understand the theory on the financial implications of an organisation's financial environment

- *Definitions of efficient markets*
- *Different forms of efficient markets and their verifications*
- *Implications of efficient markets for strategic financial decisions*

Paper III Financial Management

Syllabus content

Part 1 – Financial Management (Weighting 70%)

8) Manage an organisation's financing operations

- *Basic sources of long-term financing*
- *Patterns of long-terms financing*
- *The process of issuing equity securities*
- *Under pricing of IPOs*
- *Types of long-term debt*
- *Indentures and debt covenants*
- *Credit analysis and bond ratings*

Paper III Financial Management

Syllabus content

Part 1 – Financial Management (Weighting 70%)

9) Understand the financial implications of an organisation's capital structure

- *Financial leverage and returns to shareholders*
- *The Modigliani and Miller propositions*
- *Financial distress costs*
- *Agency costs of debt*
- *Determinants of capital structure*

Paper III Financial Management

Syllabus content

Part 1 – Financial Management (Weighting 70%)

10) Understand financial implications of an organisation's dividend policy

- *The Modigliani and Miller irrelevance proposition*
- *Arguments for relevancy of pay-out decisions*
- *Stock repurchases*

Paper III Financial Management

Syllabus content

Part 2 – Economics (Weighting 15%)

1) Understand the macro economic environment faced by business enterprises

- *Demand and supply of factors of production*
- *Monetarist and Keynesian views of economy*
- *Economic growth, inflation and unemployment*

Paper III Financial Management

Syllabus content

Part 2 – Economics (Weighting 15%)

2) Understand the micro economics applicable to business enterprises

- *The relevancy of demand and supply to business enterprise*
- *Theory of production: economy of scale and efficient use of various factors of production*
- *Market competition: monopoly, oligopoly and perfect markets*

Paper III Financial Management

Syllabus content

Part 3 – Statistics (Weighting 15%)

1) Understand the techniques used in collecting and presenting business information

- *Qualitative and quantitative aspects of business information*
- *Discrete and continuous data*
- *Statistical presentation: histograms, pie charts, frequency polygons, etc.*

Paper III Financial Management

Syllabus content

Part 3 – Statistics (Weighting 15%)

2) Understand the techniques used in analysing business data

- *Measurement of central tendency: mean, mode and median, etc.*
- *Measurement of spread: standard deviation, quartile, coefficient of skewness*
- *Sampling and statistical inference*

Paper III Financial Management

COURSE CONTENT

LECTURE 1 – Scope of Financial Management & Financial Implications of Organisation Environment

LECTURE 2 – Methods of Investment Appraisal
LECTURE 3 – Financial Risks in Investment Portfolios

LECTURE 4 – Bonds and Stocks
LECTURE 5 – Financing Operations
LECTURE 6 – Capital Structure
LECTURE 7 – Dividend Policy
LECTURE 8 – Economics - I
LECTURE 9 – Economics - II
LECTURE 10 – Statistics

Presentation Schedule

Fridays and
Public Holiday

Examination Trends

PBE Paper 3 Financial Management

		Dec-06	Jun-06	Dec-05	Jun-05	Dec-04	Jun-04	Dec-03	Jun-03	Dec-02		Total	%
Lecture 1	Scope of Financial Management & Finanicla Implications of Organization Environment		5		10	10			20	5		50	4.6%
Lecture 2	Methods of Investement Appraisal	12		20	15	20	40	20	10	20		157	14.5%
Lecture 3	Financial Risks in Investment Portfolios	20	30	30	20	10	10	10	10	20		160	14.8%
Lecture 4	Bonds and Stocks				10	10	10	10	10			50	4.6%
Lecture 5	Financing Operations		20	10	5			4		10		49	4.5%
Lecture 6	Captial Structure	48	5	20	10	20	20	26	20	10		179	16.6%
Lecture 7	Dividend Policy		20		10	10		10	10	20		80	7.4%
Lecture 8	Economics I	10	5	10	5	15	15	15	15	10		100	9.3%
Lecture 9	Economics II	10	15	10	15	5	5	5	5	5		75	6.9%
Lecture 10	Statistics	20	20	20	20	20	20	20	20	20		180	16.7%
	Total	120	120	120	120	120	120	120	120	120		1080	100.0%

LECTURE 1

SCOPE OF FINANCIAL MANAGEMENT & FINANCIAL IMPLICATIONS OF ORGANISATION ENVIRONMENT

SCOPE OF FINANCIAL MANAGEMENT

- ***Outline the scope of financial management and compare it to management accounting and financial accounting***
- ***Describe the goals of corporate firms.***
- ***Understand the different forms of business organizations***
- ***Explain how agency problems can occur and how they can be minimized.***

For supplementary guidance see Chapter 1 in your HKIAAT Study Manual.

FINANCIAL IMPLICATIONS OF ORGANISATIONAL ENVIRONMENT

- ***Identify the general role of financial intermediaries***
- ***Explain the role of commercial banks as providers of funds (including the creation of credit)***
- ***Discuss the risk/return trade-off***
- ***Identify the international money and capital markets and outline their operation***
- ***Explain the functions of a stock market and corporate bond market***
- ***Explain the key features of different types of security in terms of the risk/return trade-off.***

For supplementary guidance see Chapter 2 in your HKIAAT Study Manual.

Let's Start !!

1. The scope of financial management

Definition

Financial management covers all the functions concerned in attempting to ensure that financial resources are obtained and used in the most effective way to secure attainment of the objectives of the organisation.

1. The scope of financial management

The role of the financial manager is separated into three main areas:

- ***the raising of finance***
- ***the efficient allocation of financial resources***
- ***Maintaining control over the resources to ensure objectives are met.***

1.1 Financing

- ***Organization must have the right amount of capital***
- ***available at the right time***
- ***to work towards its objectives.***
- ***Short, medium and long-term funds may be used to invest in fixed assets and working capital depending on the organisation's requirements.***
- ***Once the funding requirements have been identified,***

1.1 Financing

- ***a choice between the most appropriate sources of capital***
- ***taking into account: cost, availability, term of finance and risk.***
- ***The most common source of capital is internally-generated surpluses from operations. However, use of this may affect dividend policy and capital structure.***
- ***External funds may be raised from a variety of financial institutions and individuals, in the form of both equity and debt financing.***

1.2 Resources – Allocation and Control

The allocation of resources - appropriate areas receive additional financial resource.

- *how this is split between fixed and current assets (working capital),*
- *levels of risk and return expected based on the requirements of the organisation will ensure that issues such a gearing are well within control.*
- *continually monitored to ensure that the various activities undertaken by the organisation continue to make maximum contribution to the achievement of the organisational objectives.*

1.3 Financial management, management accounting and financial accounting

- ***Financial management is concerned with the long-term raising of finance and the allocation and control of resources.***
- ***The management accountant will be concerned with providing information for the more day-to-day functions of control and decision-making. This will involve budgeting, cost accounting, variance analysis, and evaluation of alternative uses of short-term resources.***
- ***Financial accounting - concerned with providing information about the historical results of past plans and decisions. The purpose is to keep the owners (shareholders) and other interested parties informed of the overall financial position of the business.***

2 Goals of Corporate Firms

2.1 Importance of financial strategy

- ***An organisation's strategy is a course of action, including the specification of resources required, to achieve a specific objective or goal.***
- ***Financial strategy is that part of the overall organisational strategy that falls within the scope of the financial manager.***

2 Goals of Corporate Firms

Financial managers concern themselves with questions such as the following:

- ***From which sources should funds be raised?***
- ***Should proposed investments be undertaken?***
- ***How large a dividend should be paid?***
- ***How working capital should be controlled, e.g. should discounts be offered to debtors for prompt payment?***
- ***Should hedging strategies be adopted to avoid currency risk or interest rate risk?***

2.2 Financial strategy and overall corporate strategy

Each level of a business can have its own strategy. Three levels are commonly identified.

- ***Corporate strategy concerns the decisions to be made by senior management- e.g. enter new markets or withdraw from current market,***
- ***Business strategy concerns the decisions to be made by the separate strategic business units (SBU) - to maximise its competitive positions within its chosen market.***
- ***Operational strategy concerns how the different functional areas within a SBU - to satisfy the corporate and business strategies being followed.***

2.3 Shareholders expectations

Within any economic system, the equity investors provide the risk finance.

- *Shareholders' wealth is affected by two main factors:*
- *the **rate of return** earned on the shares,*
- *the **risk attached** to earning that return.*
- *For a quoted company, expectations about these two factors will play a major part in determining the market price of the shares.*

Return can be measured by earnings or dividends, and capital appreciation.

Earnings per share (EPS)

- ***The profit, or earnings, measure is familiar to accountants, and the earnings per share is often used as a measure of returns to equity.***
- ***Earnings per share (EPS) =***

$$\frac{\text{Attributable equity profit for the period}}{\text{Number of equity shares in issue}}$$

Earnings per share (EPS)

- ***The disadvantage of EPS is that it does not represent the income of the shareholder.***

- ***Rather, it represents the investor's share of profits generated by the company according to an accounting formula.***

Dividend yield

$$\text{Dividend yield} = \frac{\text{Actual dividend paid per share}}{\text{Market price per share}} \times 100\%$$

- The dividend yield provides a direct measure of the wealth received by a shareholder.
- It is incomplete in that it ignores the **capital gain** on the share which most investors would expect.

Dividend yield and capital growth

- ***The addition of capital growth provides a more complete measure of return.***

- ***The total return earned by an investor comprises two elements: income and capital growth.***

2.4 Managerial objectives

- **The principal objective of a company is maximisation of shareholder wealth. However, the actions taken by a company are decided upon by its managers (directors).**
- ***Managers could be interested in maximising the sales revenue of the firm or the number of employees so as to increase their own prestige and improve their career prospects.***
- ***Alternatively they could be interested in maximising their personal short-term financial return by increasing salaries or managerial 'perks'. It is also important to note that different groups of managers may be following differing objectives.***

2.4 Managerial objectives

This could lead to conflicts of interest that might occur between managers and shareholders especially in the following circumstances:

2.4 Managerial objectives

- ***Takeovers- Managers* in a target company often '*defend*' their companies against takeover. However, *shareholders* in companies that are *successfully taken over* often earn large *financial returns*.**
- ***Time horizon-* Managers' performance is usually judged on their *short-term* achievements. *Shareholder wealth* on the other hand is affected by the *long-term performance* of the firm.**

2.4 Managerial objectives

- ***Risk-*** ***Shareholders appraise risks by looking at the overall risk of their investments in a wide range of shares. Managers, whose career prospects and short-term financial remuneration, depend on the success of their individual firm.***
- ***Gearing (leverage)-*** ***The higher a company's gearing ratio, the higher the risk faced by the shareholders. As managers are likely to be more cautious over risk than shareholders they might wish to adopt lower levels of gearing than would be optimal for the shareholders.***

Summary

- ***Managers' objectives*** *will often be concerned with the* ***short-term stability*** *of the firm (and thus their jobs) which may conflict with the* ***longer-term growth*** *objectives of the* ***shareholders.***
- ***The effect of conflict of interest between managers and shareholders can be minimised by the design of a remuneration scheme that encourages decisions that are in the interest of the shareholders.***

Management compensation

Types of remuneration scheme include the following:

- A bonus based upon a minimum level of pre-tax profit
- ***A share option scheme or the award of shares***
- ***A bonus based on turnover growth***
- ***Avoiding rewards for failure***

3 Agency problems

- ***The relationships between the various interested parties in the firm are often described in terms of agency theory.***
- ***Agency theory examines the duties and conflicts that occur between parties who have an agency relationship.***
- ***Agency relationships occur when one party, the principal, employs another party, the agent, to perform a task on their behalf.***

Examples

- managers can be seen as the agents of shareholders, employees as the agents of managers, managers and shareholders as the agents of long- and short-term creditors, etc. In most of these principal-agent relationships conflicts of interest will exist.
- Although the actions of all parties are united by one mutual objective of wishing the firm to survive, the various principals involved might make various arrangements to ensure their agents work closer to their own interests.

Examples

- ***For example, shareholders might insist that part of management remuneration is in the form of a profit related bonus. The most effective method is one of long-term share option schemes to ensure that shareholder and manager objectives coincide.***

3.1 Goal congruence

Definition:

- ***Goal congruence** is the term which describes the situation when the goals of different interest groups **coincide.***

3.1 Goal congruence

- ***To achieve goal congruence between shareholders and managers is by the introduction of carefully designed remuneration packages for managers which would motivate managers to take decisions which were consistent with the objectives of the shareholders.***

remuneration packages

Important factors ***to include in such schemes are:***

- ***The schemes should be easy to monitor, clearly defined and impossible to manipulate by managers.***
- ***Management compensation should be linked to changes in shareholder wealth, if possible reflecting the managers' contribution to increased shareholder wealth.***

remuneration packages

- ***The time horizon of managers should match that of shareholders. For example, if shareholders require long-term share price maximisation managers should be encouraged to take decisions in line with this objective and not decisions that maximise short-term profits.***
- ***Shareholders' and managers' attitudes to risk should be encouraged to be similar although this is extremely difficult since shareholders can diversify away part of their risk, but managers cannot easily do this.***

Types of remuneration schemes include:

- ***A bonus based upon a minimum level of pre-tax profit***
- ***A bonus linked to the economic value added (EVA)***
- ***A bonus based on turnover growth***
- ***An executive share option scheme (ESOP)***

FINANCIAL IMPLICATIONS OF ORGANISATIONAL ENVIRONMENT

4 Financial intermediation

- **Intermediation refers to the process whereby potential borrowers are brought together with potential lenders by a third party, the intermediary.**
- **There are many types of institutions and other organisations that act as intermediaries in matching firms and individuals who need finance with those who wish to invest.**

4.1 Clearing banks

- ***Banks provide a payment and cheque clearing mechanism.***
- ***They offer various accounts to investors and provide large amounts of short to medium-term loans to the business sector and the personal sector.***
- ***They also offer a wide range of financial services to their customers.***

4.2 Investment banks

Investment banks, sometimes called merchant banks, offer the following services:

(a) Financial advice to business firms

- ***Financial advice is necessary in order to obtain investment capital, to invest surplus funds, to guard against takeover, or to take over others.***
- ***Increasingly, the merchant banks have themselves become actively involved in the financial management of their business clients and have had an influence over the direction these affairs have taken.***

4.2 Investment banks

(b) Providing finance to business

- ***Merchant banks also compete in the services of leasing, factoring, hire-purchase and general lending.***
- ***They are also the gateway to the capital market for long-term funds because they are likely to have specialised departments handling capital issues.***

4.2 Investment banks

(c)Foreign trade

- ***A number of merchant banks are active in the promotion of foreign trade by providing marine insurance, credits, and assistance in appointing foreign agents and arranging foreign payments.***
- ***It will work closely with its business clients, and will be more ready to take business risks and promote business enterprise than a clearing bank.***
- ***It is probably fair to say that a merchant bank is essentially in the general business of creating wealth and of helping those who show that they are capable of successful business enterprise.***

4.3 Finance companies

These come in three main varieties:

- ***Finance houses, providing medium-term instalment credit to the business and personal sector.***
- ***Leasing companies, leasing capital equipment to the business sector. They are usually subsidiaries of other financial institutions.***
- ***Factoring companies, providing loans to companies secured on trade debtors, are usually bank subsidiaries. Other debt collection and credit control services are usually on offer.***

4.4 Pension funds

- ***These collect funds from employers and employees to provide pensions on retirement or death. As their outgoings are relatively predictable they can afford to invest funds for long periods of time.***

4.5 Insurance companies

- ***These use premium income from policyholders to invest mainly in long-term assets such as bonds, equities and property.***
- ***Their outgoings from their long-term business (life assurance and pensions) and their short-term activities (fire, accident, motor insurance, etc) are relatively predictable and therefore they can afford to tie up a large proportion of their funds for a long period of time.***

4.6 Investment trusts and unit trusts

- ***Investment trusts** are limited liability companies collecting funds by selling shares and bonds and investing the proceeds, mainly in the ordinary shares of other companies.*
- ***Funds at** their disposal are limited to the amount of securities in issue plus retained profits, and hence they are often referred to as '**closed end funds**'.*
- ***Unit trusts** on the other hand, although investing in a similar way, find that their funds vary according to whether investors are **buying new units** or **cashing in old ones**.*
- ***Both offer substantial diversification opportunities to the personal investor.***

5 The banking system

5.1 The clearing banks

- The clearing banks participate in systems which simplify daily payments so that all the thousands of individual customer payments are reduced to a few transfers of credit between the banks.
- The money for which the banks are responsible comes chiefly from their customers' sight and time deposits – mostly current and deposit accounts.
- The money they receive is lent out in a variety of ways, in order to achieve maximum return but with sufficient liquidity to repay customers as required.

5.2 Forms of lending

1 Inter-bank lending

- ***Short-term lendings between banks are referred to as 'inter-bank' loans. The inter-bank markets in sterling and euro currencies are the largest of the short-term lending markets (money markets).***

5.2 Forms of lending

2 Buying Treasury bills

- *The clearing banks and discount houses also hold the government's own short-term securities (Treasury bills), which operate in much the same way as commercial bills.*

3 Buying commercial or trade bills

- *These constitute a definite agreement to pay a certain sum of money at an agreed place and time. A bill is really a sophisticated IOU which is of very great value in foreign trade because it allows exporters to give credit to foreign buyers and yet obtain payments from banks as soon as goods are shipped.*

5.2 Forms of lending

4 Loans to customers

- ***The clearing banks lend widely to individuals, private business customers, companies and organisations in the public sector. They do so by overdraft term facilities and loans repayable in instalments during an agreed period.***

5 Trade investments

- ***There are many specialist financial and lending activities that the banks are reluctant to handle through their general branches. They prefer to finance these indirectly through the ownership and overall control of specialist subsidiaries. Such activities include the following:***

5.2 Forms of lending

- ***Hire-purchase, much of it for the purchase of motor vehicles.***
- ***Leasing, i.e. hiring vehicles or equipment as opposed to purchase or hire-purchase.***
- ***Factoring and invoice discounting, i.e. lending to business firms on the security of approved trade debts or taking over responsibility for the collection of trade debts.***

6 Financial and capital markets

6.1 The role of financial markets

- ***The financial markets, both capital and money markets, are places where those requiring finance (deficit units) can meet with those able to supply it (surplus units).***
- ***They offer both primary and secondary markets.***

6 Financial and capital markets

- ***Primary markets* provide a focal point for borrowers and lenders to meet. Primary markets deal in new issues of *loanable funds*. They raise new finance for the deficit units.**
- ***Secondary markets* allow *holders of financial* claims (surplus units) to realise their investments before the maturity date by selling them to other investors. A well-developed secondary market should also reduce the price volatility of securities, as regular trading in ‘*secondhand*’ securities should ensure smoother price changes.**

6 Financial and capital markets

Secondary markets help investors achieve:

(a) Diversification

- ***By giving investors the opportunity to invest in a wide range of enterprises it allows them to spread their risk. This is the familiar 'Don't put all your eggs in one basket' strategy.***

(b) Risk shifting

- ***Deficit units, particularly companies, issue various types of security on the financial markets to give investors a choice of the degree of risk they take.***

6 Financial and capital markets

(c) Hedging

- ***Financial markets offer participants the opportunity to reduce risk through hedging which involves taking out counterbalancing contracts to offset existing risks.***
- ***For example, if a Hong Kong exporter is awaiting payment in euros from a French customer he is subject to the risk that the euro may decline in value over the credit period.***
- ***To hedge this risk he could enter a counterbalancing contract and arrange to sell the euros forward (agree to exchange them for Hong kong dollars at a fixed future date at a fixed exchange rate).***
- ***In this way he has used the foreign exchange market to insure his future HK$ receipt. Similar hedging possibilities are available on interest rates and on equity prices.***

6 *Financial and capital markets*

(d) Arbitrage

- ***Arbitrage is the process of buying a security at a low price in one market and simultaneously selling in another market at a higher price to make a profit.***
- ***Although it is only the primary markets that raise new funds for deficit units, well-developed secondary markets are required to fulfil the above roles for lenders and borrowers.***

6.2 The capital markets

Capital markets deal in longer-term financing (longer than one year).

- ***The major types of securities dealt on capital markets are as follows:***
- ***public sector and foreign stocks***
- ***company securities***
- ***Eurobonds. -***

  Eurobonds are bonds denominated in a currency other than that of the national currency of the issuing company (nothing to do with Europe!). They are also called international bonds.

6.3 The money markets

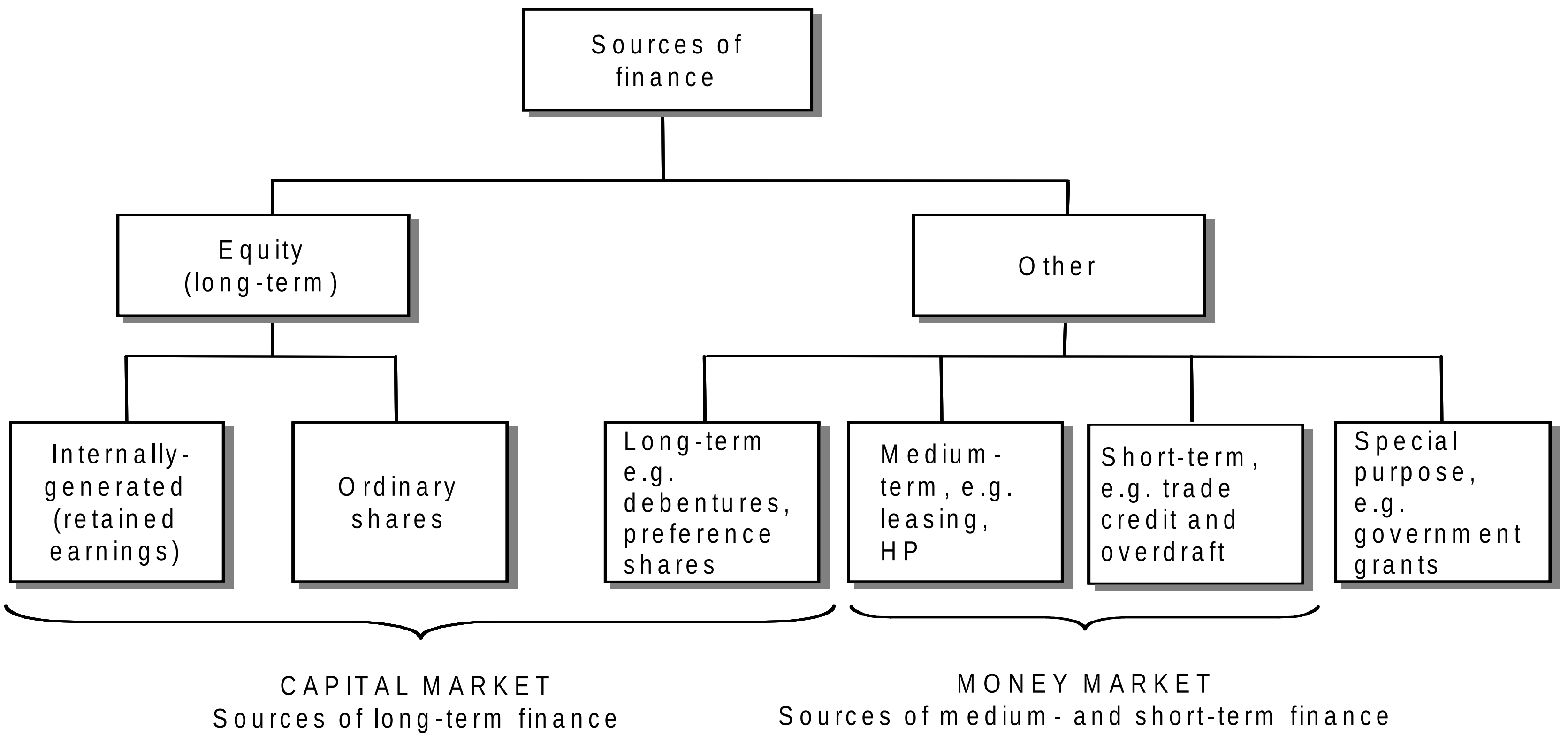
- *Money markets deal in* ***shorter-term funds****, usually in the form of bank bills, trade bills, certificates of deposit, unsecured loans and other types of credit.*
- *No physical location exists, transactions being conducted by telephone or telex.*
- ***The money market is a market mainly for short-term and very short-term loans, in both HK$ and other currencies, though some longer-term transactions are also undertaken.***

6.3 The money markets

- ***The main participants in these markets are the central banks and the commercial banks.***
- ***Other participants include the finance houses, building societies, investment trusts and unit trusts, local authorities, large companies, and some private individuals.***

6.4 Sources of finance

There are a number of possible classifications of funds. We will limit our focus to the distinction between long-term and short-term funds.



6.4 Sources of finance

- *Definitions of long-term, medium-term and short-term finance are somewhat elastic but the following durations can be taken as a rough guide.*
- ***Short-term Up to one year.***
- ***Medium-term 1 year to 7 years.***
- ***Long-term 7 years or more.***

7 International capital markets

An international financial market exists where

- *domestic funds are supplied to a foreign user or*
- *foreign funds are supplied to a domestic user.*
- *The currencies used need not be those of either the lender or the borrower.*

International capital markets

The most important international markets are:

- *the Euromarkets*
- *the foreign bond markets.*

7.1 The Euromarkets

- *The markets originated in the 1950s, dealing in Eurodollars, but now encompass other currencies including Euro-yen, Euro-sterling, Euro-Swiss and so on.*
- *Eurocurrency is money deposited with a bank outside its country of origin. For example, money in a US dollar account with a bank in London is Eurodollars.*

7.1 The Euromarkets

- *Note that these deposits need not be with European banks, although originally most of them were.*
- *Active Euromarket centres exist in London, New York, Tokyo, Singapore and Bahrain. Once in receipt of these Eurodeposits, banks then lend them to other customers and a Euromarket in the currency is created.*

7.2 Types of Euromarket

The Eurocurrency market

- *This incorporates the short- to medium-term end of the Euromarket. It is a market for borrowing and lending eurocurrencies. Various types of deposits and loans are available.*
- ***Deposits vary from overnight to five years. Deposits can be in the form of straight-term deposits, with funds placed in a bank for a fixed maturity at a fixed interest rate. However, these carry the problem of interest rate penalties if early repayment is required.***
- ***Alternatively, deposits can be made in the form of negotiable Certificates of Deposit (CDs).***

7.2 Types of Euromarket

- ***Deposits can be made in individual currencies or in the form of 'currency cocktails' to allow depositors to take a diversified currency position.***
- ***Euromarket loans may be in the form of straight bank loans, lines of credit (similar to overdraft facilities) and revolving commitments (a series of short-term loans over a given period with regular interest rate reviews).***

7.2 Types of Euromarket

- ***Small loans may be arranged with individual banks, but larger ones are usually arranged through syndicates of banks.***
- ***Much of the business on the Eurocurrency market is interbank, but there are also a large number of governments, local authorities and multinational companies involved. Firms wishing to use the market must have excellent credit standing and wish to borrow (or deposit) large sums of money.***

7.2 Types of Euromarket

- ***The Eurobond market***
- A **Eurobond** is a bond issued in more than one country simultaneously, usually through a syndicate of international banks, denominated in a currency other than the national currency of the issuer.
- ***This represents the long-term end of the Euromarket.***
- ***The bonds can be privately placed through the banks or quoted on stock exchanges. They may run for periods of between three and twenty years, and can be fixed or floating rate.***

7.2 Types of Euromarket

- ***Convertible Eurobonds (similar to domestic convertible loan stocks) and Option Eurobonds (giving the holder the option to switch currencies for repayment and interest) are also used.***
- **The major borrowers are large companies, international institutions like the World Bank, and the EC. The most common currencies are the US dollar, the euro, the Swiss franc, and to a smaller extent, sterling.**

8 Stock markets

8.1 The role of a stock market

- **A country's stock market is the institution that embodies many of the processes of the capital market.**
- **market for the issued securities of public companies, government bonds, loans issued by local authority and other publicly owned institutions, and some overseas stocks.**

8 Stock markets

- A stock market assists the allocation of capital to industry; if the market thinks highly of a company, that company's shares will rise in value and it will be able to raise fresh capital through the new issue market at relatively low cost.
- On the other hand, less popular companies will have difficulty in raising new capital.

8 Stock markets

- **Any consideration of a stock market has to face up to the problem of speculation, i.e. gambling. It is suggested that speculation can perform the following functions.**

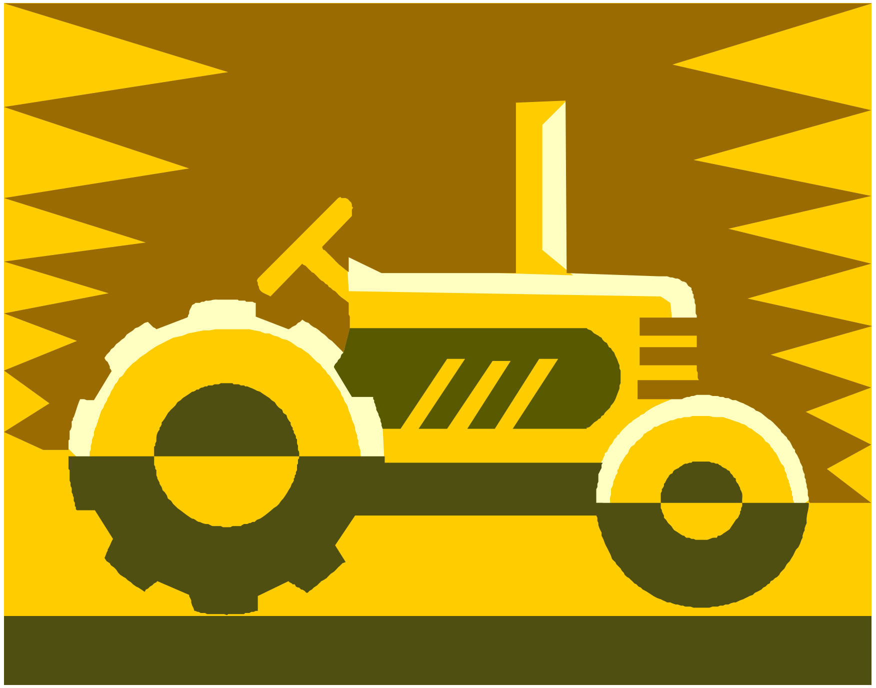
•It **smoothes price fluctuations.** Speculators, to be successful, have to be a little ahead of the rest of the market.
•Speculation ensures that **shares are readily marketable**. Almost all stock can be quickly bought and sold, at a price. Without the chance of profit there would be no professional operator willing to hold stock or agree to sell stock that is not immediately available.
•Stock markets help in the **determination of a fair price for assets**, and ensure that assets are readily **marketable**.

8.2 Types of stock market

A country may have more than one securities market in operation. For illustration, Hong Kong has the following:

(a) The Stock Exchange of Hong Kong Limited (SEHK) – This exchange was established in 1980 to consolidate four exchanges and is the main board for companies with a proven track record. The Hang Seng Index (HIS) is the benchmark indicator.

(b) The Growth Enterprise Market (GEM) – This is a separate market that was established in 1999 to encourage the development of companies in emerging and growth industries. The Growth Enterprise Index (GEI) is the benchmark indicator.



End of Lecture Presentation