Securities Operations Foundation Qualification (SOFQ) - Slide Script

Module 1.1: Introduction to International Securities – Key Players in International Securities

This is the first section of our training in which we will set the scene in which financial market transactions take place and so where Securities Operations will live. The section is divided into four modules

- Key Players in Securities Markets
- Debt and Equity products
- The Primary market
- The Secondary market

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In this module we will be looking at the International Securities Markets. We will start by first defining what are financial securities and then we will move on to discuss the market participants, the issuers, investors and intermediaries.

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Let's start with our definition: International securities are financial products that evidence money moving within the market. We will see that they come in different forms, and these forms will give different rights and obligations. These securities come about through a process we call disintermediation.

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Traditionally if someone were looking to raise money they would go to a bank and they would borrow it from this bank. Under a disintermediated model we are still going to see a bank, or other financial institution, involved but this time they are going to raise the funds for the borrower. They will do this by finding a lender who has funds and matching this with a borrower looking for money. The funds will then flow directly from lender to borrow – all facilitated by the bank who has expertise in how best to achieve this, which will ideally be through creating financial securities.

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So, in this example the borrower issues a security that is then bought by the lender. These securities will have a couple of key features, and the first is that they will be transferable, meaning the lender, the buyer of our security, can sell it on to someone else. This is what we will go on to call providing liquidity. The second is that they will be negotiable in value. Obviously if we are selling them on, potentially lots of times, at different points in time they may be more or less attractive, and this will be shown in the price that is negotiated. These securities will trade in our financial market where we will see the market participants executing the trades. Let's look at who are these participants.

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Participants will fall into 3 categories:

- Issuers;

- Investors;
- Intermediaries

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Let's look at these in turn, starting with issuers. As we saw in the diagram these are the ones wanting to raise funds, raise money in the market. They can do this is either of two ways. They can borrow money, as we showed in our example, but alternatively they could issue equity, or sell part of themselves. This means that they are raising money on a permanent basis if they issue equity or on a temporary basis if they issue debt. We will go on to see in the next module where we focus our attention on the products, that these are very different ideas and not all issuers can use both mechanisms, it depends who they are.

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So, now let's think about who are the issuers.

First off, let's talk about governments. Governments are major issuers of financial securities, although they are a perfect example of an issuer that cannot issue equity. You cannot buy shares in Germany! Instead they can only issue debt, which they do on a regular basis.

Next we have cities, regions, a group that we generically call quasi-sovereigns. These are entities that are not countries but are linked with countries. Again, these issuers cannot issue equity, they can only borrow money. We said you can't buy shares in Germany, by the same token you cannot buy shares in Frankfurt.

Our third example is supranational agencies, and example of this would be the World Bank and the EIB, who are both very large issuers in the markets. These agencies are owned by more than one country – so again they cannot issue equity, only debt. So now, we have three examples of types of issuer in the market who cannot use equity but only debt, which shows you a large bias in the market: we will find a lot more debt deals being brought to the market rather than equity deals.

Our next example is banks. Banks are able to issue both debt and equity, and we will see them very regularly issuing securities.

Finally, we have corporations. Again, corporations can issue debt or equity, as they choose. One thing we will say, though, is that most of the corporations who use our international financial markets will be large, very often multinational corporations. This is a lot to do with the reasons that issuers use financial markets.

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So, why do these issuers use financial markets? The first point is that financial markets are for raising funds for capital projects. Indeed we call this the capital markets. So, to use this market it would make sense that the issuers have a requirement to raise funds for a capital project. Financial markets are also all about raising wholesale funds – wholesale funds being large amounts, normally hundreds of millions or billions of dollars, or other currency equivalent. Again, this will explain why our corporate issuers will be large corporations. These are the ones who need this size of funds. An issuer may issue a very large size deal, let's say $1 billion, but this will not be sold to one investor. Instead it will be sold to a number of investors, the deal will be fragmented. This allows us to find many potential investors, many potential sources of funds.

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Let's move on then to look at investors.

These are the providers of funds. They will be the buyers of our securities, fulfilling that movement from those that have to those that want. When an investor decides where and how to invest they will consider two things, the risk of the trade and the return they will receive. Given the list of issuers we have just considered, and that we have the choice of debt and equity, we can start to appreciate the range of risks and returns that will be available – the breadth of the market. If we couple this with having investors with different appetites for risk and return we start to understand how our market can function, moving money from investors to issuers of all types.

When we look at the investors we can see two main types. First, we have individual, and then we have institutional investors.

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Let's look first at individuals.

This group is also known as retail. Retail, by contrast with wholesale, means small size. So this tells you that most individual investors will be providing small size funds to our issuers. So, since individuals normally trade in small size each of their deals are rather insignificant. However, if we add them all together we find they are not insignificant, their significance comes in aggregated size.

Institutional investors are firms that trade wholesale size in our markets.

We will see that they trade for themselves and also on behalf of others, managing other people's money. We will generically call these asset managers.

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Looking first at some self-investors, we will see that our governments and quasi-sovereigns will be investors as well as issuers. They all need to keep some money in their reserves, governments more so than quasi-sovereigns, and this money will need to be invested. The same is true of supranational agencies. Although for the most part their purpose is to fund development projects, they will need to maintain some cash. And again the same is true of banks and corporations. Whilst in most cases they are what we call net borrowers, in other words they have more need for funds than they have funds to invest, there are exceptions. So, all in all, we find her all of our issuers.

Moving on to the asset managers and we can see some different types of company. The first we have here are pension funds who are managing money to provide for their customers' pensions. These can be in-house pension funds, the funds of a particular company, but there are also firms who manage pension funds on behalf of a number of companies. They provide expertise in financial markets to try and achieve the best returns.

Second we have insurance companies. They sell insurance policies and need to invest in financial markets in order to ensure that they have the funds to pay out on these policies, if necessary. They also run savings schemes, particularly for those retail investors who prefer to invest indirectly rather than directly in the market.

This is idea of indirect investment leads us to our third example, that we call asset management companies. These are firms who run client portfolios. These can either be managed money, investing on behalf of a known client, or collective investment schemes. These are where the company designs a portfolio of investments and invites people to place their money into a fund to buy part of this whole

portfolio. These investors will be institutions or, again, individual investors. These are things like mutual funds and investment trusts. To give a sense of the size of this market, the biggest asset management company is Blackrock with more than $ 6 trillion under management.

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Of course, we need to ask why investors use financial markets and the biggest reason is variety. Think about the different issuers we have identified and we start to get a sense of the variety of homes for their money. We also have a wide range of different products, all with different risks and rewards. So, from this we can see how they can build up diversified portfolios.

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Our last group of participants are the intermediaries. These are the firms that put the buyers and sellers, borrowers and lenders together. In our market we will see them with two roles. Initially they will make the securities that we have been discussing. This is the primary market. But they don't stop there. Going forward they will be involved in the secondary markets, providing liquidity by finding new investors if someone wants to come out of a deal, and sometimes stepping in themselves to take on the risk. We will look at the Primary market in module 3 of this section and the Secondary market in module 4.

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Most of our intermediaries will be banks, specifically the investment banking parts of banks. Financial markets is an investment bank activity. We do have some non-bank financial firms but they tend to be more specialist, for example specialising in equities rather than debt, whilst the banks are more generalist. In terms of why intermediaries use financial markets the biggest reason is going to be to generate profit. This is a profit-making business for intermediaries. We should say, though, that financial markets is very much a relationship business and a large part of what the intermediaries are doing is to provide a service to their customers, helping issuers to raise funds they need and helping investors find a home for their funds and earn a return. The last point is about raising the profile of the firm. We will see that financial securities are most commonly issued in the public domain so everyone can see and follow the securities. This will often mean that the intermediaries that bring the deals to the market will often be linked with these deals, and so raise their profile.

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Before we go on we should check if there are any questions.

Don't forget that we have the Discussion Board where you can post any questions that you may have.

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Finally, let's conclude our module.

We have been looking at issuers, investors and intermediaries. You should make sure you are happy with what they are, what they do in the flow of financial market products and why they are in the market.

Before you go on you have three questions to answer before we move on to Module 2 where we will look more at the products themselves. This will be the same at the end of every module, just to make sure you are building up your knowledge.