What Does Finance Mean? Its History, Types, and Importance Explained

What Is Finance?

Finance is a term for matters regarding the management, creation, and study of money and investments. It involves the use of credit and debt, securities, and investment to finance current projects using future income flows. Because of this temporal aspect, finance is closely linked to the time value of money, interest rates, and other related topics.

Finance can be broadly divided into three categories:

- Public finance
- Corporate finance
- Personal finance

There are many other specific categories, such as behavioral finance, which seeks to identify the cognitive (e.g., emotional, social, and psychological) reasons behind financial decisions.

Understanding Finance

"Finance" is typically broken down into three broad categories: Public finance includes tax systems, government expenditures, budget procedures, stabilization policy and instruments, debt issues, and other government concerns. Corporate finance involves managing assets, liabilities, revenues, and debts for a business. Personal finance defines all financial decisions and activities of an individual or household, including budgeting, insurance, mortgage planning, savings, and retirement planning.

History of Finance

Finance, as a study of theory and practice distinct from the field of economics, arose in the 1940s and 1950s with the works of Harry Markowitz, William F. Sharpe, Fischer Black, and Myron Scholes, to name just a few.[2][3][4] Particular realms of finance—such as banking, lending, and investing, of course, money itself—have been around since the dawn of civilization in some form or another.

The financial transactions of the early Sumerians were formalized in the Babylonian Code of Hammurabi (circa 1800 BC). This set of rules regulated ownership or rental of land, employment of agricultural labor, and credit.[5] Yes, there were loans back then, and yes, interest was charged on them—rates varied depending on whether you were borrowing grain or silver.

By 1200 BC, cowrie shells were used as a form of money in China. Coined money was introduced in the first millennium BC. King Croesus of Lydia (now Turkey) was one of the first to strike and circulate gold coins around 564 BC—hence the expression, "rich as Croesus."[6]

In ancient Rome, coins were stored in the basement of temples as priests or temple workers were considered the most honest, devout, and safest to safeguard assets. Temples also loaned money, acting as financial centers of major cities.[7]

Early Stocks, Bonds, and Options

Belgium claims to be home to the first exchange, with an exchange in Antwerp dating back to 1531.[8] During the 16th century, the East India Company became the first publicly-traded company as it issued stock and paid dividends on proceeds from its voyages.[9] The London Stock Exchange was created in 1773 and was followed by the New York Stock Exchange less than 20 years later.[10][11]

The earliest recorded bond dates back to 2400 B.C., as a stone tablet recorded debt obligations that guaranteed repayment of grain.[12]

During the Middle Ages, governments began issuing debts to fund war efforts. In the 17th century, the Bank of England was created to finance the British Navy.[13] The United States also began issuing Treasury bonds to support the Revolutionary War.[14]
Options contracts can be found dating back to the Bible. In Genesis 29, Laban offers Jacob the option to marry his daughter in exchange for seven years of labor. However, this example demonstrates the difficulty of preserving obligations, as Laban reneged the agreement after Jacob's labor was complete.

In Aristotle's 4th-century philosophical work Politics, the early practice of options is outlined through an anecdote by the philosopher Thales. Believing a great future harvest of olives in the coming year, Thales pre-emptively acquired the rights to all olive presses in Chios and Miletus.[16] Regarding options on an exchange, both forward and options contracts were integrated into Amsterdam's sophisticated clearing process by the mid-17th century.[17]

Advances in Accounting

Compound interest—interest calculated not just on principal but on previously accrued interest—was known to ancient civilizations (the Babylonians had a phrase for "interest on interest," which basically defines the concept). But it was not until medieval times that mathematicians started to analyze it in order to show how invested sums could mount up: One of the earliest and most important sources is the arithmetical manuscript written in 1202 by Leonardo Fibonacci of Pisa, known as *Liber Abaci*, which gives examples comparing compound and simple interest.

The first comprehensive treatise on book-keeping and accountancy, Luca Pacioli's *Summa de arithmetica, geometria, proportioni et proportionalita*, was published in Venice in 1494.[18] A book on accountancy and arithmetic written by William Colson appeared in 1612, containing the earliest tables of compound interest written in English. A year later, Richard Witt published his *Arithmeticall Questions* in London in 1613, and compound interest was thoroughly accepted.

Towards the end of the 17th century, in England and the Netherlands, interest calculations were combined with age-dependent survival rates to create the first life annuities.

Public Finance

The federal government helps prevent market failure by overseeing the allocation of resources, distribution of income, and stabilization of the economy. Regular funding for these programs is secured mostly through taxation.[19] Borrowing from banks, insurance companies, and other governments and earning dividends from its companies also help finance the federal government.

State and local governments also receive grants and aid from the federal government. Other sources of public finance include user charges from ports, airport services, and other facilities; fines resulting from breaking laws; revenues from licenses and fees, such as for driving; and sales of government securities and bond issues.

Corporate Finance

Businesses obtain financing through a variety of means, ranging from equity investments to credit arrangements. A firm might take out a loan from a bank or arrange for a line of credit. Acquiring and managing debt properly can help a company expand and become more profitable.

Startups may receive capital from angel investors or venture capitalists in exchange for a percentage of ownership. If a company thrives and goes public, it will issue shares on a stock exchange; such initial public offerings (IPO) bring a great influx of cash into a firm. Established companies may sell additional shares or issue corporate bonds to raise money. Businesses may purchase dividend-paying stocks, blue-chip bonds, or interest-bearing bank certificates of deposits (CD); they may also buy other companies in an effort to boost revenue.

Personal Finance

Personal financial planning generally involves analyzing an individual's or a family's current financial position, predicting short-term, and long-term needs, and executing a plan to fulfill those needs within individual financial constraints. Personal finance depends largely on one's earnings, living requirements, and individual goals and desires.

Matters of personal finance include but are not limited to, the purchasing of financial products for personal reasons, like credit cards; life and home insurance; mortgages; and retirement products. Personal banking (e.g., checking and savings accounts, IRAs, and 401(k) plans) is also considered a part of personal finance.

The most important aspects of personal finance include:

- Assessing the current financial status: expected cash flow, current savings, etc.

- Buying insurance to protect against risk and to ensure one's material standing is secure
- Calculating and filing taxes
- Savings and investments
- Retirement planning

As a specialized field, personal finance is a recent development, though forms of it have been taught in universities and schools as "home economics" or "consumer economics" since the early 20th century. The field was initially disregarded by male economists, as "home economics" appeared to be the purview of housewives. Recently, economists have repeatedly stressed widespread education in matters of personal finance as integral to the macro performance of the overall national economy.

Social Finance

Social finance typically refers to investments made in social enterprises including charitable organizations and some cooperatives. Rather than an outright donation, these investments take the form of equity or debt financing, in which the investor seeks both a financial reward as well as a social gain.

Modern forms of social finance also include some segments of microfinance, specifically loans to small business owners and entrepreneurs in less developed countries to enable their enterprises to grow. Lenders earn a return on their loans while simultaneously helping to improve individuals' standard of living and to benefit the local society and economy.

Social impact bonds (also known as Pay for Success Bonds or social benefit bonds) are a specific type of instrument that acts as a contract with the public sector or local government. Repayment and return on investment are contingent upon the achievement of certain social outcomes and achievements.

Behavioral Finance

There was a time when theoretical and empirical evidence seemed to suggest that conventional financial theories were reasonably successful at predicting and explaining certain types of economic events. Nonetheless, as time went on, academics in the financial and economic realms detected anomalies and behaviors which occurred in the real world but could not be explained by any available theories.

It became increasingly clear that conventional theories could explain certain "idealized" events—but that the real world was, in fact, a great deal more messy and disorganized, and that market participants frequently behave in ways that are irrational, and thus difficult to predict according to those models.

As a result, academics began to turn to cognitive psychology in order to account for irrational and illogical behaviors which are unexplained by modern financial theory. Behavioral science is the field that was born out of these efforts; it seeks to explain our actions, whereas modern finance seeks to explain the actions of the idealized "economic man" (*Homo economicus*).

Behavioral finance, a sub-field of behavioral economics, proposes psychology-based theories to explain financial anomalies, such as severe rises or falls in stock price. The purpose is to identify and understand why people make certain financial choices. Within behavioral finance, it is assumed the information structure and the characteristics of market participants systematically influence individuals' investment decisions as well as market outcomes.

Daniel Kahneman and Amos Tversky, who began to collaborate in the late 1960s, are considered by many to be the fathers of behavioral finance. Joining them later was Richard Thaler, who combined economics and finance with elements of psychology in order to develop concepts like mental accounting, the endowment effect, and other biases that have an impact on people's behavior.

Tenets of Behavioral Finance

Behavioral finance encompasses many concepts, but four are key: mental accounting, herd behavior, anchoring, and high self-rating and overconfidence.

Mental accounting refers to the propensity for people to allocate money for specific purposes based on miscellaneous subjective criteria, including the source of the money and the intended use for each account. The theory of mental accounting suggests that individuals are likely to assign different functions to each asset group or account, the result of which can be an illogical, even detrimental, set of behaviors. For instance, some people keep a special "money jar" set aside for a vacation or a new home while at the same time carrying substantial credit card debt.

Herd behavior states that people tend to mimic the financial behaviors of the majority, or herd, whether those actions are rational or irrational. In many cases, herd behavior is a set of decisions and actions that an individual would not necessarily make on his or her own, but which seem to have legitimacy because "everyone's doing it." Herd behavior often is considered a major cause of financial panics and stock market crashes.

Anchoring refers to attaching spending to a certain reference point or level, even though it may have no logical relevance to the decision at hand. One common example of "anchoring" is the conventional wisdom that a diamond engagement ring should cost about two months' worth of salary. Another might be buying a stock that briefly rose from trading around $65 to hit $80 and then fell back to $65, out of a sense that it's now a bargain (anchoring your strategy at that $80 price). While that could be true, it's more likely that the $80 figure was an anomaly, and $65 is the true value of the shares.

High self-rating refers to a person's tendency to rank him/herself better than others or higher than an average person. For example, an investor may think that he is an investment guru when his investments perform optimally, blocking out the investments that are performing poorly. High self-rating goes hand-in-hand with *overconfidence,* which reflects the tendency to overestimate or exaggerate one's ability to successfully perform a given task. Overconfidence can be harmful to an investor's ability to pick stocks, for example. A 1998 study entitled "Volume, Volatility, Price, and Profit When All Traders Are Above Average", by researcher Terrance Odean found that overconfident investors typically conducted more trades as compared with their less-confident counterparts—and these trades actually produced yields significantly lower than the market.