THE FINANCIAL SYSTEM

LECTURE 1 (FLOW OF FUNDS):

INTRODUCTION:

Surplus unit – person or company with more money than they need at the present time

Deficit unit – requires funds to make a purchase

2 Methods by which the flow of funds function is performed:

1. **Direct financing**
   - Surplus units pay for securities issued by deficit units
   - Invest in securities *e.g. bonds*
   - If cannot make repayment = lost funds

2. **Indirect financing**
   - Financial institutions raise funds from surplus units and supply funds to deficit units
   - 3rd party involved
   - Lender receives more security as bank will go after other assets if not repaid

Mismatch between surplus and deficit units:

Table 1.1 The mismatch between the preferences of surplus and deficit units

Contractual preference	Surplus units	Deficit units
1 Return on (and cost of) funds	As high as possible	As low as possible
2 Length of contract	Flexible and short	Inflexible and long
3 Risk exposure	Varies, but many are risk-averse	Risk taker
4 Amount of funds	Usually small	Usually large

RISK:

Risk – chance that expected return will not be achieved

1. **Default risk** – chance that financial obligations will not be met
2. **Market risk** – chance of loss arising from movements in market variable *e.g. interest rates, exchange rates*

Risk transfer – use of contracts to manage risk exposure *e.g. fixed interest rate = minimises market risk. Borrower gives up chance that interest rate may fall*

INFORMATION ASYMMETRY:

Information asymmetry – arises when one party to a potential contract is better informed than the other party *e.g. borrower knows more about his capacity to make repayment than the lender does*

Problems that arise:

1. Loans are made that should not be made
2. Loans are not made that should be made

Overcome in a number of ways:

1. Including provisions in contracts that encourage truthful information disclosure

2. Restricting participation in market to professional traders that are well informed about risk and potential returns
3. Financial regulations that require the more informed party to provide the relevant information *e.g. Prospectus at IPO*

INCENTIVE PROBLEMS:

Incentive problem – arise when the terms of a financial agreement provide one party with an incentive to act irresponsibly

Moral hazard – situation where the self-interest of a party in a financial agreement come into conflict with moral/ethical values

e.g. a financial advisor receives secret commissions for the investment in particular products

Goldman Sachs Example:

- *Played on information asymmetry*
- *Sold securities with prior knowledge they would fail*
- *Hedge fund made $1 billion profit on bets that securities would fail (incentive problem)*
- *GS earned fee income from both investors and the hedge fund (moral hazard)*

POOLING:

Pooling of funds – process of combining small amounts from many suppliers for lending or investment purposes

- Enhances the flow of funds

FORMS OF FINANCING:

1. Debt
2. Equity

Debt financing:

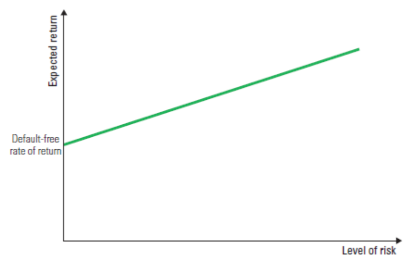
- Generally facilitated through a bank loan
- Interest paid (fixed or floating)
- Repayments
- Security agreements

Interest rates:

- Return to the supplier of funds
- Cost of debt to borrower
- Fixed rate = applies for full term of loan
- Floating = change during loan's term
- Can be viewed as a **default risk free rate plus a risk premium**

$R = r_{\text{default free}} + r_{\text{risk premium}}$

Figure 1.3 The risk and return relationship



Equity financing:

- Funds invested in a firm by its owners
- Raised through issuing ord. shares

Shareholder return:

1. Profit (dividend PMT)
2. Retained earnings (reinvestment = ^ share price)

- Referred to as **risk capital** as dividends can only be paid from retained earnings which are **residual** after a company has met its financial obligations

Comparison between debt and equity:

- Debt is cheaper especially in after tax terms = ∴ higher returns on assets
- Encourages **leverage**
- However since debt payments are commitments, too much debt = bankruptcy

	Advantages	Disadvantages
Debt	• Lower cost, partly because interest payments are tax deductible • Leverage can increase return on equity	• Risk of insolvency • Funding risk • Potential loss of secured assets • Forced asset sales may not achieve fair values
Equity	• Does not require repayment • Not obligated to pay dividends • Lowers risk of insolvency	• More expensive

TWO BASIC PRINCIPALS OF FINANCE:

1. Risk and return trade off
2. Time value of money

THE GFC:

- Collapse of the flow of funds throughout the US and global financial markets
- At root = incentive problems with lenders In the US housing market
- Crisis became global when banks became reluctant to lend

FINANCIAL INSITUTIONS:

1. Bands and other Authorised Deposit-taking Institutions (ADI's)
2. Insurance companies
3. Fund managers

BANKING SERVICES:

1. Accent deposits, make loans and provide payment services for households (retail banking) or businesses (wholesale banking)
2. Issuing securities and risk-transfer instruments and providing financial advice to large companies (investment banking services)

FINANCING MARKETS:

1. Money market – trading short term discount securities
2. Bond market – long term securities
3. Share market – trading in corporate securities

FINANCIAL SYSTEM STABILITY:

Main responsibilities:
1. Conduct of monetary policy
2. Overseeing the stability of financial system
3. Regulation of the payments system
4. Note issue
5. Being the Commonwealth Government's banker

LECTURE 2 (SETTLEMENT):
- Performed by payment system
- Existed for long time
- Evolved from barter (exchange of an item for another), precious metal, coins and notes, payment orders

EXCHANGE SETTLEMENT ACCOUNTS:
ESAs – accounts that ADIs have with the RBA to settle the payments they make to each other and with the RBA

Condition:
- Can not be overdrawn

Benefits:
1. That the RBA **transfers funds** into and out of them as required by the ADI
2. **Pays interest** on the balance at 25bps below the cash rate

RETAIL PAYMENTS SYSTEM:
- Comprises notes, coins and payment orders that are used to settle transactions
- Main retail payment orders:
    1. Direct entries
    2. Debit and credit cards
    3. Cheques
- Each must be **authorised** and **verified**

PAYMENT ORDERS:
Direct Entries – pre-authorised and verified bulk payment orders
- Cheapest
- Direct credits = inflow
- Direct debits = outflow
- Most popular form

Debit cards – issued by ADIs to their depositors to enable them access to their funds and to settle transactions
- May charge per transactions
- ATMs, EFTPOS

Credit cards – issued by credit card companies in association with ADI
- Transaction >> deposited by merchant >> merchant paid by card company's bank >> customer billed monthly
- Pays interest for length of time left unpaid