

## Topic 1 Overview of the Financial System

### SSU

Giving funds that have been earned as an income and that have not been spent on consumption or on real investment

### DSU

Takes funds from others in order to consume or do real investment now, and not for the purpose of lending to others

### Direct finance

Surplus spending units hold as an asset the financial instrument that has been issued by the deficit spending units

### Financial intermediation

The financial instrument issued by the deficit spending unit is held as an asset by a financial institution rather than by the surplus spending unit

### Debt

- borrowed funds, also known as 'credit'
- commits the borrower to make the agreed interest and loan repayments
- failure to make payments can result in bankruptcy

### Equity

- funds invested in a firm or in an asset by its owners
- does not commit the deficit unit to make payments

## Debt versus equity

For a company that requires additional funds:

	Advantages	Disadvantages
Debt	<ul style="list-style-type: none"><li>• Lower cost, partly because interest payments are tax deductible</li><li>• Leverage can increase return on equity</li></ul>	<ul style="list-style-type: none"><li>• Risk of insolvency</li><li>• Funding risk</li><li>• Potential loss of secured assets</li><li>• Forced asset sales to repay debt may not achieve fair values</li></ul>
Equity	<ul style="list-style-type: none"><li>• Does not require repayment</li><li>• Not obligated to pay dividends</li><li>• Lowers risk of insolvency</li></ul>	<ul style="list-style-type: none"><li>• More expensive</li></ul>