The Financial System

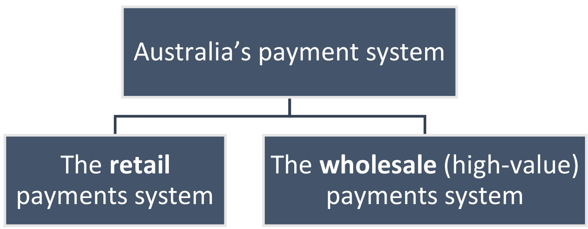
LECTURE 1

*A financial system consists of **financial institutions**, **markets** and **instruments** that together provide financial services for the economy*

– Performs a number of financial functions which help us in our everyday life

The settlement function	*The arrangements that can be used to settle commercial transactions*
	– A **transaction** is an agreement between a buyer and seller to exchange an item (or service) for payment
	– Settlement occurs when a buyer exchanges **money** for a purchased item. Money includes:
	    o Cash
	    o Bank account balances, that can be used for payments through a range of electronic methods known as **payment orders** (such as debit and credit cards)

Payment Orders	*Payment orders are instructions to a bank (ADI) to pay the stated amount to the nominated party*
	– Direct debits and credits
	    o Pre-authorised payments into accounts
	    o E.g. getting paid from your employer, or automatic payments for your phone bill
	– Cheques
	    o Commonly used for large transactions
	– Debit and credit cards
	– Online payment instruments
	    o Paypal, BPay

The payments system	
The retail payments system	*Retail transactions include those between households, between households and businesses, or between businesses* – If someone pays cash to a retail payment system, then it's an easy system of placing the cash into the business account = **Immediate Settlement** – If someone pays by card, they're Westpac and the shop is commonwealth bank, it is a longer process = **Payment settlement is deferred** o The settlement of these payments requires each Authorised Deposit-taking Institutions (ADIs) to have an exchange settlement account

Exchange settlement accounts (ESA)	*A bank's actual account for the soul purchase of settling deferred payments.* ***ESAs** are funds that financial institutions hold with the Reserve Bank of Australia (RBA) to settle the payments they make to each other and with the RBA* The benefits of ESAs are: 1. the RBA **transfers funds** into and out of them as required by the ADI, enabling ADIs to provide **payment services** to their customers 2. they are **safe** 3. the RBA pays **interest** on the end-of-day balance 4. *but the accounts cannot be overdrawn* The system used to settle retail inter-bank payment orders is known as **deferred net settlement** (DNS) It involves two steps: **Clearing** – where the ADIs agree on their **NET** payment obligations to the system to be settled using ES funds: Checks the users account is the funds are there, figuring how much exactly overall that westpac's users have spent in a day ↓ **Settlement** – the actual transfer of ES funds from the paying to the receiving ADI Payments are settled as a batch periodically during the day and at 9am next business day Where Westpac puts the actual amount of money into CBAs account
The wholesale payments system	1. **Wholesale financial market transactions** from the foreign exchange, bond and money markets (about 80% of payments a day, as they're large) an **agreement** is made between the buyer and seller that specifies the terms of the trade → **settlement** occurs a specified number of days later when payment is made and ownership of the asset is transferred P + 2 = payment plus two days 2. **Transfers between ADIs** (including DNS transfers) 3. Payments between ADIs and the **RBA.** Instructions regarding the payments to be settled each day are received mostly from the clearinghouses in the debt markets (Austraclear) and FX market (SWIFT) → These payments are placed in a queue within the *Reserve Bank Information and Transfer System* (RITS) where they are processed individually throughout the day → Processing involves firstly the **clearing** of the payment – which is checking that the paying ADI has sufficient ES funds to enable payment → Once a payment is cleared it is immediately **settled** through a transfer of ES funds

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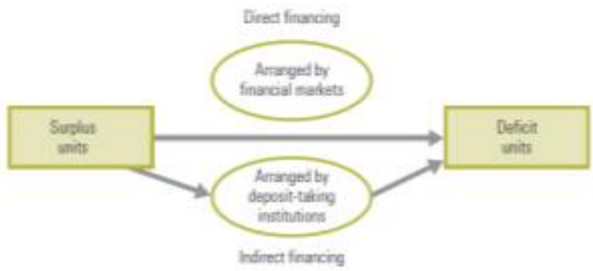
<td>The flow of funds function</td>
<td>The supply of funds for a period usually on the basis that the users compensate the suppliers for the use of their funds
• Funds are supplied by surplus units mostly as bank deposits and superannuation contributions
    • they require compensation for forgoing the immediate use of the funds and for the risk the funds will not be returned
• The deficit units that require funds include households (mostly for housing loans), businesses and the government

The deficit funds are supplied either:
1. Directly
    • Deficit units raise funds directly from surplus units through the issue of securities in the financial markets
    • Securities are contracts issued by deficit units to raise funds - they specify the promised payments by the deficit unit and can be traded in the financial markets
2. Indirectly
    • Where funds are supplied as deposits to financial institutions, which in turn supply funds as loans to deficit units
    • Superannuation funds


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<td>The Risk-transfer function</td>
<td>Risk is the possibility that returns will be lower than expected, which includes the possibility of a loss
• Default risk is the chance that financial obligations will not be met
• Market risk is the possibility of loss arising from an unexpected movement in a market variable (such as interest rates, exchange rates or share prices)

Risk-transfer contracts provide ways to manage risk exposures
⇒ arranged through trading in derivatives

A variable interest rate borrower faces the risk of an unexpected increase in interest rates
⇓
A derivative contract can be used to fix their future rate, (through an offsetting payment) but this means the borrower gives up the chance to benefit from an unexpected fall in interest rates
⇓
Such contracts will be used by borrowers that are more concerned about a paying a higher rate than missing out on a lower rate
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