MAF202 – Money and Capital Markets

Topic 1: Financial System Overview

Outline

1. Understanding a Financial System
    - Roles and functions
    - Flows of Funds
    - Financial Institutions, Financial Instruments and Financial Markets
2. Financial stability and the real economy
3. Regulatory environment – legislation & prudential supervision

What is a Financial System?

A financial system comprises three principal elements:

- financial institutions
- financial markets
- financial instruments

What does it do?

A financial system facilitates financial transactions through the

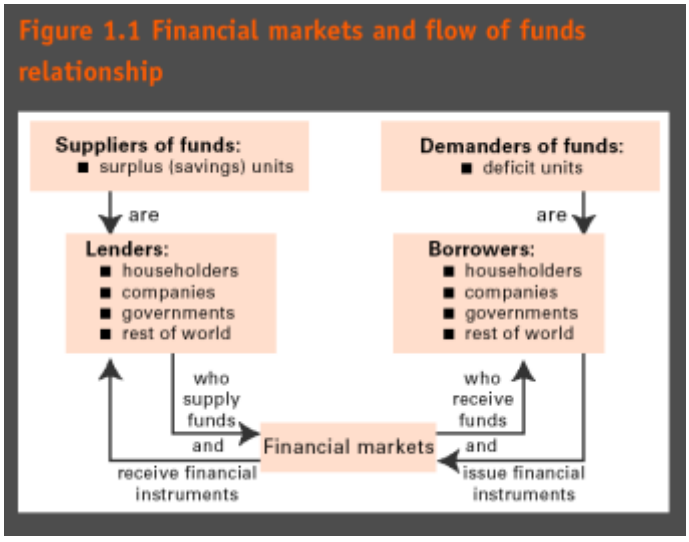
- Creation
- Sale, and
- Transfer of assets (both physical and financial assets)

What is important to a Modern Financial System?

Must have:

- Stability and public confidence
- Integrity – legal structures to enforce loan and other agreements
- Innovation – new instruments and techniques
- Efficiency of the financial system – operates at minimum cost, critical to the performance of the economy

Flow of Funds through the Financial System



Financial Institutions: Role and functions

- In a modern financial system, different types of institutions provide a wide range of products and services
- Financial institutions are classified by their sources (liabilities) and uses (assets) of funds
- Products and services provided vary between institutions depending on regulation, markets and competition
- The main purpose of financial institution is to reduce transaction costs by specialization in particular financial instruments and services

Types of Financial Institutions

1. Authorised depository institutions (ADIs)
   - Commercial Banks
   - Building Societies
   - Credit Unions
2. Non-depository financial institutions
   - Contractual savings institutions
   - Finance companies
   - Investment and merchant banks
   - Unit trusts and managed funds

<u>Assets of Financial Institutions (% of total assets)</u>

	1990	2005	2009	2015
RBA	3.4	3.1	2.2	2.2
Commercial Banks	43.8	49.1	57.3	57.1
Building Societies	3.1	0.6	0.5	0.4
Credit Unions	1.2	1.2	1.0	0.7
Money Market Corporations	7.2	2.8	1.9	0.6
Finance Companies & General Financiers	7.5	3.5	2.5	1.9
Life Insurance Offices	11.5	6.6	3.8	4.0
Superannuation Funds	10.8	15.6	17.2	22.8
Other Managed Funds Cash Management trusts etc	6.3	7.8	6.8	5.1
General Insurance & Securitisation Vehicles	5.2	9.7	6.8	5.2
Total	100	100	100	100

Financial Instruments

Can be divided into four categories:

1. <u>Equity</u>
   - *ordinary shares* issued by a company which represent an ownership position for the shareholder

- shareholder has an entitlement to receive a share of any distribution of profits of the company – dividends

2. <u>Debt</u>

Contractual claim to:

  - periodic interest payments
  - repayment of principal.

- Ranks ahead of equity
- Can be:
  - short term (money market instrument) or medium to long term (capital market instrument)
  - secured or unsecured
  - negotiable (ownership transferable; e.g. commercial bills and promissory notes) or non-negotiable (e.g. term loan obtained from a bank).
- corporate and government debt

3. <u>Hybrids</u>
   - combine the elements or characteristics of both debt and equity
   - example - an instrument issued which makes periodic interest payments, but offers a future ownership entitlement (example: convertible notes and preference shares)

4. <u>Derivatives</u>
   - a product whose pricing is *derived* from an existing product (e.g. gold)
   - not instruments issued for raising funds
   - a tool for managing risk (e.g. the risk that the price of gold may change in the future)
   - types: futures, options, swaps, forwards

Financial Markets

<u>Matching Principle</u>

- Main function of financial markets is to facilitate flow of funds between savers and borrowers
- short-term assets should be funded with short-term liabilities medium-to-longer-term assets should be funded with equity and/or medium-to-longer-term liabilities
- seeking to match the cash-flows on both sides of the balance sheet

<u>Direct and Intermediated Markets</u>

- government, business and individuals access finance to meet funding needs
- access to funding may be categorised as:
  - direct finance, or
  - intermediated finance