Topic 1: Financial System Overview

The Role and Function of a Financial System

***A financial system comprises three principal elements (most topics are based around these 3 elements):

- Financial institutions
- Financial markets
- Financial instruments

The financial system is overseen by the central bank and prudential supervisor.

A financial system facilitates financial transactions through the creation, sale, and transfer of assets (both physical and financial assets). It is a structure that facilitates transactions of goods and services.

Financial systems add benefit in that they provide a reliable way for payment to be received, a way to price a product taking into account its risk, it allows the transfer of resources from suppliers (lenders) to users (borrowers) of funds, it allows for the return to go to the supplier of the funds, and provides liquidity to whoever needs it. *As such, financial systems match lenders and borrowers according to their *required return/yield, risk, liquidity and time-pattern of cash flows (4 things) (similar to week 2 question 6).

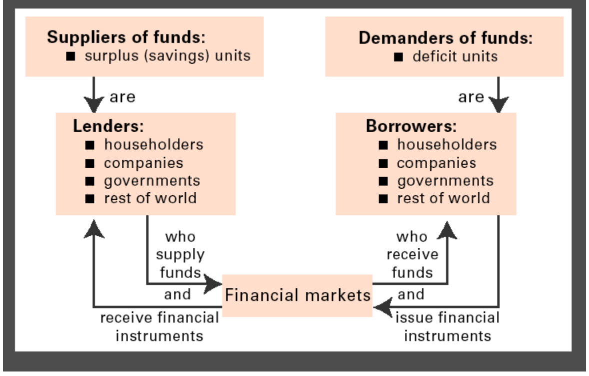
It is important that a modern financial system has:

- *Stability and public confidence - public trust will only be gained through integrity
- Integrity – *requires legal structures to enforce loan and other agreements (without these financial systems will be unable to continue). To keep up integrity the system must be innovative and efficient.
- Innovation – for example, introduce new instruments and techniques such as online payment
- Efficiency of the financial system – it must operate at minimum cost, which is critical to the performance of the economy (requires the use of economies of scale)

Furthermore, the wide range of financial products in a financial system facilitates portfolio structuring, and provides economic and financial information to the market.

Flows of funds through the financial system

Figure 1.1 Financial markets and flow of funds relationship



This figure shows us how financial markets both receive and borrow funds from lenders/borrowers. That is, they facilitate the exchange of money between borrowers and lenders. See how the money is primarily transferred from surplus units (those who save it but don't spend) to deficit units (those who have less money than they spend). Anyone can be a lender or borrower, depending on their financial position. Due to globalisation and trading throughout the world, overseas parties can come into the lender borrower situation.

Financial Institutions – Element 1

In a modern financial system, different types of institutions provide a wide range of products and services. While some institutions offer similar products and service, typically institutions tend to specialise in areas where they have greater expertise.

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 a financial institution (e.g. a bank) is to reduce transaction costs by specialization in particular financial instruments and services. That is, they reduce the costs to because of their special knowledge.

***In effect, financial institutions such as these are deemed financial institutions because their business is about borrowing and lending money. We need these financial institutions in the market to act as a middle man to act between lenders and borrowers, because direct finance (borrower going straight to lender) cannot always occur. Most of the time, the borrower and lender require a middle man, at which point the financial institution who knows all about lending and borrowing will step in. Being the middle man is the second purpose of financial institutions.

There are 2 main types of financial institutions:

1. Authorised depository institutions (ADIs) – These institutions obtain a large proportion of their funds from deposits lodged by savers (largely deposits from households and businesses). For example, deposits placed in demand deposit accounts or term deposit accounts with Commercial Banks, Building Societies and Credit Unions.
2. Non-depository financial institutions – As the name suggests, these institutions cannot receive their funds through deposits from business and households. Examples of non-depository financial institutions include Contractual savings institutions, Finance companies, Investment and merchant banks and Unit trusts and managed funds.

Note: We cover what these examples are in greater detail in topics 2 and 3.

The key difference between these is that ADIs have licenses to take deposits from normal people, whereas non-depository financial institutions do not have a license to take a deposit, meaning they need to obtain funds from other sources (e.g. offshore).

Note: The book classifies these financial institutions into 5 categories. They are depository financial institutions (effectively ADI's), investment banks, contractual savings institutions, finance companies and general financiers and unit trusts (the last 4 are all effectively Non-depository institutions).

The graph below shows the percentage of total Assets of Financial Institutions in June 1990, 2005, 2009 and 2015 that are tied up in each financial institution (% of total assets):

	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

As such, we can tell that the commercial banks are the key financial institution, with their assets representing 57.1% of the total assets available in Australia in 2015. We can see that this figure has grown significantly over the past 25 years. This increase in the use of commercial banks in Australia has grown largely due to the dominance of the Big 4 Banks (NAB, Westpac, ANZ and Commonwealth) who have enormous market power and have large flexibility to change their prices, margin and rate of return (e.g. RBA cash rate at 1.75% whereas banks are charging 4% - huge margin). Another reason for the expansion in the use of commercial banks is changes in our banking regulations in the 1990's which allows the commercial banks to borrow offshore to fund their investments and expand further. This means they can borrow cheaply from overseas, and lend at higher rates domestically, boosting their profits (e.g. some domestic markets are 0.5% rather than 1.75% in Australia, and then when they sell at 4% their profit margins are huge).

Another large increase has been in the use of superannuation funds, which hold 22.8% of the total assets available in Australia. They have risen largely due to the increase in compulsory superannuation initially introduce in 1992, which has risen over time, and the age you can receive your super has also increased. Pre-1992, superannuation was not compulsory and therefore had a lower portion of assets. Further, an ageing population has meant that people are looking to save for their retirement.