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TOPIC 1 – Introduction to Australia's Financial System

- **Financial System:** Consists of financial institutions, markets and instruments that together provide financial services to the economy.
- Functions of the financial system:
 - Settlement of transactions
 - The flow of funds
 - Risk management
 - Overcome information asymmetry
 - To resolve incentive problems
 - To pool funds
- The settlement function:
 - Arrangements that can be used to settle commercial transactions.
 - **Transaction:** An agreement between a buyer and seller to exchange a good/service for payment.
 - **Settlement:** occurs when a buyer exchanges money for a purchased item.
 - Payment orders:
 - Instructions to a bank to pay the stated amount to the nominated party.
 - **Direct debits and credits:** Pre-authorised payment from an ADI account or a pre-authorised payment into an account.
 - Cheques
 - Debit and credit cards
 - The payments system:
 - Performs the settlement function
 - Relates to both retail and wholesale payments
 - Retail payments system:
 - Include those between households and businesses or between businesses.
 - Average daily volume of transactions is high but the average value of each transaction is much lower.
 - Transaction is settled when the seller/recipient accepts cash or a payment order.
 - Cash and same-ADI payment orders immediately settle the payment.
 - Where different ADIs are used, a system is required for the drawer's ADI to pay the funds to the recipient's ADI, settlement is deferred.
 - Deferred net settlement: System used to settle retail inter-bank payment orders
 - **Clearing:** Where the ADIs agree on their net payment obligations to the system to be settled using ES funds.
 - **Settlement:** Actual transfer of ES funds from the paying to the receiving ADI.
 - Exchange settlement account:

- Funds that financial institutions hold with the RBA to settle the payments they make to each other and with the RBA.
- All ADIs must hold an ES account with the RBA.
- Benefits:
 - RBA transfers funds into and out of the as required by the ADI, enables ADIs to provide payment services to their customers.
 - They are safe
 - The RBA pays interest on the end of day balance.
 - Cannot be overdrawn.
- The wholesale payments system:
 - Include the FX market, bond market and money market
 - Two stages:
 - Agreement made between buyer and seller that specifies the terms of trade.
 - Settlement occurs a specified number of days later when payment is made and ownership of the asset is transferred.
 - Transfers between ADIs
 - Payment between ADIs and the RBA
 - Uses real-time gross settlement:
 - Payment instructions are received from the clearinghouses in debt markets and FX market.
 - Payments are placed in a queue in the Reserve Bank Information and Transfer System (RITS) where they are processed individually through the day.
 - Processing involves clearing of the payment which is checking that the paying ADI has sufficient ES funds to enable payment
 - When a payment is cleared, it is immediately settled through a transfer of ES funds.
- Flow of funds function:
 - Supply of funds for a period on the basis that users compensate suppliers for use of their funds.
 - Funds are supplied by surplus units mostly as bank deposits and super contributions.
 - The deficit units that require funds include households, business and government.
 - Funds are supplied either:
 - Directly - Deficit units raise funds directly from surplus units through the issue of securities.
 - Indirectly – Where fund are supplied as deposits to financial institutions, which in turn supply funds as loans to deficit units.

